Case Western Reserve Law Review

Volume 74 | Issue 1 Article 4

2023

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Recommended Citation

Robert B. Thompson, *Private Ordering and Contracting Out in Twenty-First-Century Corporate Law*, 74 Case W. Rsrv. L. Rev. 13 (2023)
Available at: https://scholarlycommons.law.case.edu/caselrev/vol74/iss1/4

Case Western Reserve Law Review · Volume 74 · Issue 1 · 2023

Private Ordering and Contracting Out in Twenty-First-Century Corporate Law

Robert B. Thompson†

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† Peter P. Weidenbruch Jr. Professor of Business Law, Georgetown University Law Center. I thank Seamus Howard and Rory Farquharson for their research assistance.

Introduction

Private ordering and contracting out seem to be in the midst of a golden age in American entity law. Among closely held entities, Limited Liability Companies (LLCs) have swept the space. LLC statutes and case law proclaim the central policy "to give the maximum effect to . . . freedom of contract."[1] Close corporation law in most states goes as far, with late twentieth-century statutory authorizations that permit contracts to provide almost any governance rule the parties desire.[2] For publicly held corporations, the exculpation for director statutes enacted after *Smith v. Van Gorkom*[3] have been broadened to permit governing provisions that exculpate officers as well.[4] Other recent statutes provide authorization for contracting to relax rules on taking a corporate opportunity and to waive appraisal.[5] A third recent growth area for contracting around traditional rules has appeared in the space for start-up entities, where firms, often funded by venture capital, have pushed the envelope for contracting to change rules about voting and control when the firms are private but carry these contracted rules forward in a way that further rearranges the publicly held space.[6]

Does this mean the end of mandatory law or the end of the law's limits on contracting out? Not exactly. Even with these three areas of clearly visible changes, mandatory rules remain a key part of corporate law. Common law claims based on fiduciary duties and the statutory claim for oppression, for example, remain available for closely held entities.[7] The efforts to contract around fiduciary duties in public corporations remain bounded and courts remain vigilant in policing questionable contracting.[8] The extent to which startups are able to take their contracting rules into public markets is still developing.[9] Yet, these changes necessitate updating our template as to the reach of

1. Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999) (quoting Del. Code Ann. tit. 6, § 18-1101(b) (1992)). *See generally infra* Part I.A.
2. *See* Model Bus. Corp. Act § 7.32 (Am. Bar Ass'n 2023); *see also Model Business Corporation Act Resource Center*, Am. Bar Ass'n., https://www.americanbar.org/content/dam/aba/administrative/business_law/corplaws/enactment-table.pdf [https://perma.cc/93UP-9UJJ] (depicting the states that have and have not adopted the Model Business Corporation Act).
3. 488 A.2d 858 (Del. 1985).
4. *See generally infra* Part II.B.
5. *See infra* Part II.B.
6. *See infra* Part II.C.
7. *See infra* Part II.A.
8. *See infra* Part II.B.
9. *See infra* Part II.C.

private ordering in our business entities and the limits that remain in the various contexts.

This Article proceeds as follows: Part I provides a brief historical examination of the origins of mandatory corporate law and an initial dramatic move away from that paradigm at the end of the nineteenth century. Part II examines modern changes in private ordering and contracting out in the three areas—closely held entities, publicly held corporations, and startups backed by venture capital with contracting terms that carry forward with the entity when it goes public. Part III probes in more detail the reasons that have propelled greater acceptance of contracting away from mandatory legal rules, such as fiduciary duties or centralized control, and examines the limits that continue to be applied in each space.

The justifications for mandatory rules vary in the different contexts with distrust of contract in these settings for a variety of reasons. For example, participants in closely held entities regularly can't or don't protect themselves against legal rules of centralized control or majority rule that may open them up to harm by co-venturers who control the business. It may be too costly to bargain, or they feel unable to bargain effectively without breaking the trust necessary for the business to survive, or they may lack sufficient knowledge about what could happen. Shareholders in publicly held entities may own too small a stake or be unable to effectively coordinate against managers or controlling shareholders. Markets or intermediary funds that hold most shares in American public companies (usually for beneficiaries in company-sponsored and tax-favored retirement plans) may not be attuned to particular issues. Startups may include some sophisticated investors, but the business may move too fast such that the bargaining failed to address various important issues that can become relevant when the company's shares become more widely held.

I. Early (More Mandatory) Corporate Law and the Private Ordering Wave of the Nineteenth Century

The central reason for forming corporations has always been to gain legal recognition of the entity as separate from the individuals behind it in order to use one or many of the characteristics that follow from separateness. Initially, separateness could achieve something as simple as cross-generational conveyancing and contracting as to property.[10] Early illustrations can be found in religious uses of corporations so that property remained for the charitable use of monasteries or bishoprics beyond the lives of the original actors and was not transferred to the

10. Margaret M. Blair, *Corporate Personhood and the Corporate Persona,* 2013 U. Ill. L. Rev. 785, 787.

heirs of a particular person.[11] Other early uses of separate entities provided autonomy for groups to determine rules within a profession (e.g., guilds)[12] or a geographic space (e.g., several of the American colonies were established and governed by chartered entities).[13]

The sovereign's right to create (or not create) corporations established a set of mandatory rules and boundaries that limited the space for private action and contracting.[14] A corporation's duration and its purpose were typically defined by the charter that was granted.[15] Whatever autonomy there was came from the sovereign and then from the American states that succeeded to the monarch's sovereignty after the American Revolution.[16] Early American governments "significantly restricted associations' access to the benefits that came from being legal entities or legal persons," preferring politically neutral entities and disadvantaging organizations viewed as "socially or politically disruptive."[17]

Across the nineteenth century and in the wake of the Industrial Revolution, the American states repeatedly modified their laws to endow their corporations with new characteristics helpful to owning a business—e.g., limited liability,[18] a governance hierarchy establishing

11. *Id.* at 789; *see also* David Ciepley, Governing People or Governing Property? 2 (Feb. 18, 2021) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3796298 [https://perma.cc/ED9H-GQ8H] (discussing medieval Europe's viewing corporations through the lens of property, while failing to include the principal purpose of improving governance of people and property).

12. Blair, *supra* note 10, at 789 (quoting RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720–1844, at 17 (2000)).

13. *Id.* at 793.

14. HARRIS, *supra* note 12, at 17.

15. Blair *supra*, note 10, at 791 (comparing trading-company charters that typically lasted for a "limited number of years" to religious-institution charters which granted "perpetual succession in the holding of property").

16. *Id.* at 793.

17. *See* Ruth H. Bloch & Naomi R. Lamoreaux, *Voluntary Associations, Corporate Rights, and the State: Legal Constraints on the Development of American Civil Society, 1750-1900*, 4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 21153, 2015); *see also* Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression*, *in* CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY 125, 127 (Edward L. Glaeser & Claudia Goldin eds., 2006) (stating that pressure mounted to "prevent a favored few from engrossing" the benefits of corporations in the nineteenth century).

18. Robert B. Thompson, *Why New Corporate Law Arises: Implications for the Twenty-First Century*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? 6 (Steven Davidoff Solomon & Randall

centralized control (in a board of directors) and majority rule,[19] perpetual duration,[20] and a lock-in of investor funds.[21] In what, in retrospect, can be identified as a major shift to private ordering and contracting out in American corporate law, the states moved to "general incorporation statutes" that essentially removed state power over the incorporation choice, putting it in the hands of private actors.[22] This was most starkly visible in a series of state enactments of enabling statues in the 1890s and thereafter, first by New Jersey and followed by the other states, with Delaware soon becoming the recognized pacesetter, a role it continues to hold today.[23]

Even with the broad flexibility given to private parties under these enabling statutes, this first contracting-out movement to some extent simply masked a shift of the regulatory impulses from the state to the federal government. There were a host of new federal statutes regulating

Stuart Thomas eds., 2019). Limited liability of shareholders was not in evidence for American corporations until Massachusetts and other states added that element to their corporation's code between 1830 and 1853. Phillip I. Blumberg, *The Corporate Entity in an Era of Multinational Corporations*, 15 Del. J. Corp. L. 283, 295 n.25 (1990).

19. Blair, *supra* note 10, at 796; *see also* Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business 14–16, 50–51 (1977) (seeing decentralized governance shared by all participants through the 1840s); E. Merrick Dodd Jr., *Statutory Developments in Business Corporation Law, 1886-1936*, 50 Harv. L. Rev. 27, 40–42 (1936) (tracing broadening powers for directors over the nineteenth century).

20. Elizabeth Pollman, *Corporate Personhood and Limited Sovereignty*, 74 Vand. L. Rev. 1727, 1734 (2021).

21. *Id.* at 1735–36. In contrast to traditional partnership rules of an easy exit for members who wished to depart—a manifestation of how fragile the separateness characteristics were in those entities—the corporate form conditioned return of any participant's investment in the entity on the approval of the board. *See generally* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387 (2003); Morgan Ricks, *Organizational Law as Commitment Device*, 70 Vand. L. Rev. 1303, 1306 (2017).

22. Thompson, *supra* note 18, at 6; Eric Hilt, *When Did Ownership Separate from Control? Corporate Governance in the Early Nineteenth Century*, 68 J. Econ. Hist. 645, 650–52 (2008).

23. Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 Del. J. Corp. L. 249, 265, 273 (1976). Professor (later Supreme Court Justice) Wiley Rutledge described this period as "destined eventually not only to reverse the historic policy of the states toward corporations, but to place state policy . . . fundamentally in opposition to that of the Federal Government." Wiley B. Rutledge, Jr., *Significant Trends in Modern Incorporation Statutes*, 22 Wash. U. L.Q. 305, 307 (1937).

significant corporate behavior in, for example, antitrust,[24] safety and employee protection statutes,[25] and prohibition of corporate political contributions.[26] Further, state corporate law itself retained significant spaces of mandatory rules for which contracting out did not seem possible, for example, fiduciary duty and limits on mergers and other fundamental changes.[27]

Even for areas like voting and control, in corporation statutes, there was what was sometimes referred to as a "statutory norm"—specifying centralized control in the board and actions by majorities that could not be changed.[28] The corporation statutes did provide that the certificate could limit or restrict the power of the board or majorities via clauses added to the certificate, a method which insured this flexibility and, in the words of a leading twentieth-century Delaware-law commentator S. Samuel Arsht, "aided those promoters who were determined to assure to management the dominant position in the corporation."[29] Thus, the corporate form of the early twentieth century was perceived as imposing a statutory norm of immutability of governance by directors that led to courts' blocking shareholder agreements naming officers and their compensation or requiring the unanimous vote of shareholders for certain corporate acts normally done by directors. In *McQuade v. Stoneham*,[30] for example, the New York high court ruled that stockholders could not contract to place limits on "the power of directors . . . to manage the business . . . by the selection of defined agents at defined salaries."[31]

24. *See, e.g.*, Sherman Anti-Trust Act of 1890, ch. 647, 26 Stat. 209 (codified as amended at 15 U.S.C. §§ 1–7) (prohibiting activities that restrict interstate commerce and competition in the marketplace).

25. *See, e.g.*, Interstate Commerce Act of 1887, ch. 104, 24 Stat. 379 (repealed and recodified as amended at 49 U.S.C. § 11501) (requiring railroad rates to be reasonable and just).

26. *See, e.g.*, Tillman Act of 1907, ch. 420, 34 Stat. 864 (codified as amended at 52 U.S.C. § 30118(a)).

27. *See infra* Part II.B.

28. *See* Clark v. Dodge, 199 N.E. 641, 642 (N.Y. 1936).

29. S. Samuel Arsht, *A History of Delaware Corporation Law*, 1 Del. J. Corp. Law 1, 10 (1976) (describing the impact of the 1899 addition of what is now section 102 of the Delaware General Corporation Law).

30. 189 N.E. 234 (N.Y. 1934).

31. *Id.* at 236; *See infra* Part II.A.

II. The Dramatic Shift to More Contracting Out in Contemporary Corporate Law

A reprise of this shift to private ordering and what can be termed as the modern law of contracting out illustrates parallel contemporary movements in three different forms of business associations described below. All three had their origins in the corporate form that had evolved across previous centuries discussed in Part I.

A. Closely Held Firms

By the middle of the last century, a contracting-out movement began to gain traction, most noticeably in closely held firms, moving beyond the paradigm described in Part I.[32] At the time, these were usually firms identified as close corporations—enterprises with a small number of shareholders who often knew each other and each actively participated in multiple roles within the business. The same individuals usually were simultaneously the sources of the firm's financial capital, provided its human capital in doing the day-to-day work, and were the decision-makers and managers of the firm (shareholders, directors, and officers, in the vocabulary of corporate law statutes).[33]

The mandatory governance rules of the statutory norms described in Part I—all entity decisions by the board and a majority shareholder able to elect all the directors—meant much more vulnerability to a participant left in a minority status after a fallout among the parties (and even a cursory awareness of human behavior reveals the not-insubstantial likelihood of that occurring). Two further characteristics of a close corporation combined to enhance the vulnerability of the minority's position. First, unlike an investor in a publicly held company, the lack of a market of the corporation's shares meant the minority had no source of liquidity as would a shareholder in a publicly held enterprise, closing off the most attractive solution for shareholders who find themselves in an unsatisfactory investment. Second, the participant in the closely held company would likely have much more riding on this illiquid investment than an investor in a publicly held company. In a publicly held company, the investor was usually a stranger to the entity, having made a capital investment (likely as part of a diversified portfolio of stock investment in various entities). In contrast, the involvement with the closely held corporation was likely much more intense. Not only had the participant committed his or her capital, but the firm was also the receptacle for the participant's human capital, so that if there was a fall out, much more of the participant's life and well-being

32. *See* Willard P. Scott, *The Close Corporation in Contemporary Business*, 13 Bus. Law. 741, 741–44 (1958).

33. F. Hodge O'Neal, Robert B. Thompson & Harwell Wells, O'Neal & Thompson's Close Corporations and LLCs: Law and Practice § 1:13 (Rev. 3d ed. 2023), Westlaw.

was tied up in the enterprise. In addition, these investments regularly occurred within the bounds of long-running family relationships, or among those with long-running ties. A fallout in this more intense relationship created vulnerability, often more than in a public corporation.

Participants in such closely held enterprises, with their investor non-stranger relationships and no public market to provide a way out, regularly sought to protect themselves with contracts that provided alternative arrangements for board control and majority rule. Even so, the corporate form of the early twentieth century was perceived as imposing a statutory norm of immutability of statutory governance by a majority of directors. In *McQuade v. Stoneham*, for example, the high court in New York held that stockholders cannot contract to place limits on the power of directors to manage the business by the selection of defined agents at defined salaries.[34] In *Benintendi v. Kenton Hotel, Inc.*,[35] another New York court held that a bylaw requiring unanimous agreement for all shareholders' and directors' action improperly interfered with the immutable rule of majority rule by directors.[36] The statutes of the time specified, as do today's statutes, that all corporate power shall be in the board, but without the broader exception for contracting out "except as may be otherwise provided in the articles" that appears in today's statutes. Corporate law at the time was only willing to go as far as allowing shareholder agreements that affected shareholder use of their power to elect directors. The flexibility did not extend to limit directors' ordinary business decisions for the corporation, such as employment or compensation of shareholders, decisions that are particularly important to a minority after a fallout among the participants.[37] During the twentieth century, statutes were added

34. 189 N.E. at 236.

35. 60 N.E.2d 829 (N.Y. 1945).

36. *Id.* at 830. *But see* Clark v. Dodge, 199 N.E. 641, 642 (N.Y. 1936) ("Where the directors are the sole stockholders, there seems to be no objection to enforcing an agreement among them to vote for certain people as officers.").

37. Scott, *supra* note 32, at 748.

regarding voting trusts,[38] shareholder pooling agreements,[39] and irrevocable proxies.[40]

In the decades after World War II, case law and some statutes (limited to corporations that had chosen to come under special close corporation statutes) authorized broader intrusion into the traditional director power.[41] Contracts via shareholders' agreements became more widespread, such as buy-sell agreements to insure some sort of liquidity rights from the entity or other investors and some guarantee of a continuation of their role in the business.[42]

By the end of the twentieth century, the Model Business Corporation Act, which provides the basis for the corporations law in two-thirds of American states,[43] had embraced a broad approach to contracting out that "validates virtually all types of shareholder agreements that, in practice, normally concern shareholders and their advisors."[44] The hostility to contracting out in close corporations had disappeared.

38. Model Bus. Corp. Act § 32 (Am. Bar Ass'n 1950) (currently at § 7.30 (2023)); 56 Del. Laws ch. 50, § 218(a) (1967) (codified as amended at Del. Code Ann. tit. 8, § 218(a) (2023)).

39. Model Bus. Corp. Act § 34 (Am. Bar Ass'n 1969) (currently at § 7.31 (2023)); 56 Del. Laws ch. 50, § 218(c) (1967) (codified as amended at Del. Code Ann. tit. 8, § 218(c) (2023)). For an early case about shareholder pooling agreements, see Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, Inc., 49 A.2d 603, 604–09, 611 (Del. Ch. 1946), *modified*, 53 A.2d 441 (Del. 1947). In a corporation with three shareholders, two had joined in a pooling agreement to control the corporation to the exclusion of the third—with an agreement to let an arbitrator decide what to do if the two could not agree. After a dramatic and fatality-producing circus fire led to criminal charges against the husband of one of the two shareholders, the other party's unsympathetic reaction to the husband's plight led the first party to seek to end the alliance and join with the previously excluded third shareholder in violation of the pooling agreement. The court was unsympathetic to the effort to void the agreement on the basis of the statutory norm. For the full story of the case, see J. Mark Ramseyer, *The Story of* Ringling v. Ringling: *Nepotism and Cycling at the Circus*, *in* Corporate Law Stories 135–61 (J. Mark Ramseyer ed., 2009).

40. Model Bus. Corp. Act § 31 (Am. Bar Ass'n 1950) (currently at § 7.22) (2023); 56 Del. Laws ch. 50, § 212 (1967) (codified as amended at Del. Code Ann. tit. 8, § 212(e) (2023)).

41. O'Neal et al., *supra* note 33, § 1:24.

42. *Id.* § 4:11.

43. *Model Business Corporation Act Resource Center*, Am. Bar Ass'n., https://www.americanbar.org/content/dam/aba/administrative/business_law/corplaws/enactment-table.pdf [https://perma.cc/93UP-9UJJ] (depicting the states that have and have not adopted the Model Business Corporation Act).

44. Model Bus. Corp. Act § 7.32(a) cmt. (Am. Bar Ass'n 2023).

In the twenty-first century, a new form of entity—the limited liability corporation (LLC)—came to dominate the closely held space (for reasons more related to tax and liability concerns).[45] As to contracting out, this new business form not only followed the trail blazed by the corporations statutes but also put freedom of contract at the core of this new business form. A Delaware decision in 1999 noted that its legislature had chosen "to give the maximum effect to the principle of freedom of contract."[46] As states wrote their LLC statutes for these new business forms, they went even further to make this point. Under traditional corporate law, the starting point was the statute and then parties could move away from the statute by following the rules set out for making changes. In some LLC statutes, the legislature reversed this pattern. The contract (usually called an "operating agreement") was the starting point. The LLC statute governed only in the absence of an operating agreement.[47] There are some limits in the LLC statutes where contracting can be limited as discussed below (i.e., limits on waiver of fiduciary duty and a member's rights to seek judicial dissolution for oppressive conduct by a majority interest holder), but the space for contracting is considerably broader than entity law of a few decades earlier.

B. Publicly Held Firms

There has been a very visible shift in corporate law empowering more private ordering and authorizing parties to contract around what had been mandatory legal rules as they apply in the publicly held setting. The most prominent modern examples have granted permission to modify common law rules on fiduciary duty and also some core statutory protections for shareholders such as appraisal.

1. Contracting Out of Fiduciary Duty

a. Duty of Care

Fiduciary duties of care and loyalty traditionally were viewed as mandatory without provision for contracting out. Reaction to *Smith v. Van Gorkom*, decided by the Delaware Supreme Court in 1985, provoked a sea change in how private ordering was viewed in public corporations. In *Van Gorkom*, the court held the directors of Trans Union Corporation, a publicly held corporation, liable for breach of their fiduciary duty of care in their approval of an arm's length cash-out merger that provided all the Trans Union shareholders a 35 percent premium above the highest price the corporation stock had traded over

45. *See* O'Neal et al., *supra* note 33, § 1:9.

46. Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 295 (Del. 1999).

47. *See* Unif. Ltd. Liab. Co. Act § 105(a) (Unif. L. Comm'n 2013).

the previous five years.[48] Trans Union's CEO, board, and senior management had worked for years to increase its share price, focusing particularly on the company's inability to generate sufficient taxable income against which to offset large investment tax credits it regularly received for its purchase of railcars that were central to the company's business.[49] After prior efforts to get Congress to change the tax law were unsuccessful and a series of acquisitions failed to generate sufficient income to offset the tax credits, the company turned to sell to a buyer with a large amount of taxable income that could be offset by the unused tax credits.[50] The court's majority found the directors had breached their duty of care in failing to adequately inform themselves of the CEO's role in the sale (he had sought out the buyer and suggested to the buyer how a takeover at a merger price he suggested could be financed), had failed to adequately research the intrinsic value of the company, for example, by getting a fairness opinion from an investment banker, and were grossly negligent in approving the sale on two hours' consideration, without prior notice.[51]

The decision sparked a quick response along two dimensions. Insurance companies providing indemnity insurance to directors and officers reevaluated their rates and coverage in light of the new standard, and there were stories of directors resigning from company boards because of increased liability risks.[52] When the Delaware legislature next convened, the Delaware Corporation Law Council had a director-exculpation statute to send to the legislators.[53] A statutory amendment was passed that permits Delaware corporations to include provisions in their certificate of incorporation that eliminate personal liability of a director for monetary damages for breach of certain fiduciary duties, defined by the statute to essentially cover breaches of

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48. 488 A.2d. 858, 866, 869, 874, 893 (Del. 1985).

49. *Id.* at 864–65.

50. *Id.*

51. *Id.* at 874. The dissenters, in what was a 3-2 case, focused on the qualifications of the outside directors who "knew Trans Union like the back of their hands and were more than well qualified to make on the spot informed business judgments concerning the affairs of Trans Union including a 100% sale of the corporation." *Id.* at 895 (McNeilly, J., dissenting).

52. Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 Bus. Law. 1, 6 (1985); Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 Del. J. Corp. L. 1, 1–2 (1989).

53. *Section 102(b)(7) of the Delaware General Corporation Law,* Univ. of Pa. Carey L. Sch., https://www.law.upenn.edu/live/news/7005-section-102b7-of-the-delaware-general-corporation#oralhistory [https://perma.cc/H462-US75] (oral history interview recordings and transcripts).

care.[54] The language of the statute specifically rules out exculpation of duty of loyalty, transactions from which the director derived an improper personal benefit, or acts/omissions not in good faith or which involve intentional misconduct or knowing violation of law.[55] Most American states quickly made similar changes to their own corporations codes.[56] Publicly held corporations wasted little time in amending their certificates of incorporation to include such exculpation.[57]

With this form of private ordering permitted, the liability crisis receded. Almost forty years later, in 2022, the Delaware legislature returned to this issue and amended its statute to also permit provisions in the certificate of incorporation that permitted exculpation of officers.[58] The Model Business Corporation Act also moved to make a similar change in its statute.[59] While more controversial than the director exculpation, the protection against officer liability will likely also be widely used.

b. Contracting Out of Business Opportunity

Changing views toward contracting out in the fiduciary duty space can be seen in the duty of loyalty space, which is fenced off from private ordering under Delaware General Corporation Law (DGCL) section 102(b)(7). A 1989 case, *Siegman v. Tri-Star Pictures, Inc.*,[60] presented the traditional view that reductions in the duty of loyalty were not contractable, whether through a provision in the article or bylaws, through a board resolution, or through a contractual term.[61] The court relied on the specific exculpation for the duty of loyalty in

54. 65 Del. Laws ch. 289, § 2 (1986) (codified as amended at DEL. CODE ANN. tit. 8, § 102(b)(7) (2023)).

55. DEL. CODE ANN. tit. 8, § 102(b)(7) (2023).

56. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1209, 1211 (1988).

57. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1786 (2004) ("It is very rare for a public company not to have taken advantage of this exculpation.").

58. 83 Del. Laws ch. 377, § 1 (2022) (codified as amended at DEL. CODE ANN. Tit. 8, § 102(b)(7)(v) (2023)) (adding a new exception that does not permit provisions to eliminate or limit officer liability "in any action by or in the right of the corporation").

59. MODEL BUS. CORP. ACT § 8.56 (AM. BAR ASS'N 2023).

60. No. 9477, 1989 WL 48746 (Del. Ch. May 30, 1989).

61. *Id.* at *8. *See* Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers,* 117 COLUM. L. REV. 1075, 1092 (2017).

section 102(b)(7) as a basis for its opinion.[62] Yet changes on the ground were creating stress for the traditional rules. Technology changes spawned new ownership structures in startups, including increasing the number of firms that had overlapping ownership or board members with interests in the same industry.[63]

An earlier Delaware opinion had illustrated the value in allowing parties to include directors with conflicting interests without necessarily triggering conflict obligations. In *Broz v. Cellular Information Systems, Inc.*,[64] a company (CIS) had intentionally chosen to include on its board the sole shareholder (Broz) of a competing company.[65] When a license for an area adjacent to both the existing service areas of CIS and Broz became available, Broz was the successful bidder. Another competitor later joined the bidding, and after acquiring control of CIS, argued that Broz as a director had breached his fiduciary duty to CIS in taking a corporate opportunity.[66] The Chancery Court held that Broz had breached his duty by not explicitly making the offer available to CIS.[67] The Delaware Supreme Court reversed, concluding that the seller had not approached CIS because of its severe financial troubles at the time and declined to impose an absolute rule requiring prior disclosure to the board.[68]

In 2000, Delaware law was amended to permit contracting out of a corporate opportunity that could have provided an alternative method to deal with the opportunity.[69] The statute is broader than previous contracting-out statutes in several ways. First, it applies to the key

62. *Siegman*, 1989 WL 48746, at *7, *8.

63. *See* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 Wash. U. L. Rev. 913, 915–16 (2021).

64. 673 A.2d 148 (Del. 1996).

65. *Id.* at 150–51.

66. *Id.* at 151.

67. Cellular Info. Sys., Inc. v. Broz, 663 A.2d 1180, 1181–82 (Del. Ch. 1995), *rev'd*, 673 A.2d 148 (Del. 1996).

68. Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 151 (Del. 1996) ("Broz took care not to usurp any opportunity which CIS was willing and able to pursue."). The American Law Institute had suggested the broader approach in its project on corporate law. 1 Am. L. Inst., Principles of Corporate Governance: Analysis and Recommendations § 5.05 (1992).

69. 72 Del. Laws ch. 343, § 3 (2000) (codified as amended at Del. Code Ann. tit. 8, § 122 (2023)) ("Every corporation created under this chapter shall have power to . . . [r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.").

corporate actors who have fiduciary duties—officers, directors, or stockholders. The inclusion of stockholders opens the way to application to controlling shareholders, for whom Delaware has traditionally applied a more substantial showing of independence in duty of loyalty contexts.[70] Second, the manner of private ordering by which the company can renounce a corporate opportunity is broad. It can be in the certificate of incorporation (as is true for the exculpation of duty of care discussed above) or by action of the corporation's board of directors, which greatly expands the method by which the corporate action can be taken. While the first kind of action would involve stockholders, the second would not. While the first looks more like the structural change that was the basis for DGCL section 102(b)(7), the second has more in common with the contracting-out bargaining in close corporations. The discretion to directors is also broad. On behalf of the corporation, they can renounce any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities.[71]

The language of the statute leaves ambiguity still to be worked out. How broad can the categories be—i.e., can their approach be a blanket renouncement? Could the director actions be after the fact? What standard will be applied to director independence? For example, will the rule of *Aronson/Zuckerberg* be applied?[72] Will the *M & F* two-prong cleansing test developed in a control-shareholder setting be required in this renouncement of a corporate opportunity?[73] There have not yet been extensive reported cases, so difficult questions about possible director conflicts and how they might be cleansed have yet to be worked out.[74]

Gabriel Rauterberg and Eric Talley conducted an extensive empirical study of the use of this new form of private ordering and contracting

70. *See* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644–45 (Del. 2014). The *Kahn* Court imposed a more severe fiduciary duty test on cleansing possible loyalty breaches in a public corporation by requiring, ab initio, that a conflicted party satisfy a two-step cleaning by gaining (1) approval by disinterested directors and (2) approval by disinterested shareholders. If satisfied, the challenge to the defendant board against a breach of loyalty claim will be judged by the deference of the business judgment rule. *Id.*

71. § 122(17).

72. *See* Aronson v. Lewis, 473 A.2d 805, 807–08 (Del. 1984); United Food & Com. Workers Union v. Zuckerberg, 262 A.3d 1034, 1058 (Del. 2021).

73. *See Kahn*, 88 A.3d at 644–45.

74. *See* Wayne Cnty. Emps.' Ret. Sys. v. Corti, No. 3534-CC, 2009 WL 2219260, at *18 (Del Ch. July 24, 2009) (declining to rule on whether the corporate opportunities allegedly renounced were sufficiently "specified").

out and found that "[p]ublic companies have . . . a significant appetite for contracting out of the fiduciary duty of loyalty."[75] In a random sample of 1,000 disclosures by publicly traded companies in the period after the adoption of this new form of contracting out, they found almost a quarter of the disclosures dealt with a waiver of corporate opportunity.[76]

2. Contracting Out of Voting and Other Statutory Governance Provisions

Statutory rules relating to voting and other governance rules like appraisal have received lesser attention than fiduciary duty, but here, too, there is a pickup in activity relating to contracting out.[77]

a. Dual-Class Voting

An example from the early twentieth century as to voting arose out of the traditional specification of one vote for every share. Delaware law provides one vote per share unless otherwise specified in the certificate of incorporation, using the same opt out for private ordering visible in the requirement that directors exercise all powers to manage the corporation unless specified otherwise in the certificate.[78] For much of the twentieth century, the listing standards of the New York Stock Exchange (NYSE) effectively preempted this choice by banning dual-class voting, a specification that some shares would possess higher votes for their shares, thus providing control even if they only owned a minority of the issued shares.[79] Competitive pressure from other exchanges induced the NYSE to permit dual-class listings in the 1980s with a resulting spike in the use of dual-class voting, partially as a response to hostile takeovers that were increasing at the time.[80] The Securities and Exchange Commission (SEC) responded by adopting Rule 19c-4, which banned securities exchanges and other self-regulatory organizations from listing stock of dual-class companies, thus making "one share one

75. Rauterberg & Talley, *supra* note 61, at 1121–22, 1123. They found little action in the first three years after enactment, but then a substantial upsurge. *Id.* at 1124. The great majority of the contracting out was done in the charter of the company, with little effort to accomplish it through action of the board of directors. *Id.* at 1146.

76. *Id.* at 1123.

77. There have also been statutory changes relating to private ordering under rules relating to forum shopping and inspection that are not included in this discussion. *See* Del. Code Ann. tit. 8, §§ 115, 220 (2023).

78. *Id.* § 212(a).

79. *See* Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes* 73 Va. L. Rev, 807, 807 n.1 (1987) (describing NYSE rules on this point going back to the 1920s).

80. Jill Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. Rev. 1057, 1066 (2019).

vote" effectively a mandatory rule for public companies.[81] The rule was challenged by the Business Roundtable, made of up CEOs of large public companies, and the D.C. Circuit Court of Appeals struck down the agency action on federalism grounds preserving state law to govern the internal affairs of corporations.[82] No longer having to worry about the stock exchange rule or the SEC, many Silicon Valley companies and other high-tech companies have frequently used the contracting out provision to put a dual class into their initial certificate, opting out of "one share one vote."[83]

b. Appraisal

Appraisal illustrates another recent flurry of activity in the contracting-out space, but one that is somewhat more complicated than others discussed so far. Appraisal is a statutory remedy that dates back to the late nineteenth century at a time when the previous statutory requirement for unanimous shareholder approval for a merger shifted to supermajority and later to a simple-majority standard.[84] The statute permits any shareholder dissenting from the merger to essentially require the corporation to buy shares at a judicially determined fair value.[85] Statutes did not provide for contracting out of the appraisal remedy, but numerous routes to avoid appraisal developed that filled much of the same need.

The statute ostensibly gives individual shareholders of both the acquiring and target forms that are merging the right to seek the appraisal remedy.[86] It thereby provides individual holders liquidity for their investment in contrast to the usual lock-in feature of the corporate entity. In most settings, individual investors had no right to insist that the corporation redeem one's shares. Rather the only liquidity would come from a market, if there was one for the corporation's shares, or from the holder's individually finding a buyer.

But there were rather large exceptions that let corporate planners avoid the obligation to let go of their control of the investment. First, planners could accomplish essentially the same economic result as a merger by having the parties enter into a sale of assets by the target in exchange for the same cash or shares consideration that would have

81. *Id.*; Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed. Reg. 26376, 26394 (July 12, 1988).

82. Bus. Roundtable v. SEC, 905 F.2d 406, 409, 417 (D.C. Cir. 1990).

83. Fisch & Davidoff Solomon, *supra* note 80, at 1064.

84. *See* Robert B. Thompson, *Exit Liquidity and Majority Rule: Appraisal's Role in Corporate Law*, 84 Geo. L.J. 1, 3–4 (1995).

85. Del. Code Ann. tit. 8, § 262 (2023).

86. *See id.*

been used in the merger.[87] Sales of assets were a regular method of acquisition when mergers still required a unanimous vote and turned out to be an effective end-run of the merger provisions protecting individual shareholders. In Delaware, the appraisal statute does not include the sale of assets.[88] When shareholders challenged a sale of assets as a "de facto merger" with the effect of avoiding the shareholder protections, the Delaware Supreme Court declared the two methods for acquisitions had "independent legal significance"[89] and were "of equal dignity."[90]

Second, planners later introduced triangular mergers that could accomplish the same thing (from an economic perspective). They had the acquiring company form a subsidiary with the parent obtaining all the shares of that new company in exchange for the cash or stock of the parent company that would be the consideration to be used in the planned acquisition.[91] The merger then took place between the target and the subsidiary. Since the parent was not a part of the merger (even though its assets were funding it, and it would control the subsidiary), there would be no appraisal available for its shareholders. This, too, passed judicial scrutiny.[92]

There are also additional specific exclusions built into most appraisal statutes. Shareholders of surviving companies to a merger are not required to approve mergers unless there is a significant increase in the number of shares being issued (e.g., greater than 20 percent).[93] The appraisal statute excludes shareholders of the surviving corporation if no shareholder vote is required.[94] There is also a separate "market out" exception to the grant of appraisal if shareholders of any constituent party to a merger hold publicly traded shares.[95] But there is also an exception to the exception that reinstates appraisal for shareholders

87. The sale of assets would be followed by a dissolution of the target company and a pro rata distribution of the deal consideration (the only remaining asset of the target company) to the shareholders. *Id.* § 271.

88. *Id.* § 262(b) (listing ten statutory transactions that trigger appraisal rights but not including § 271).

89. Hariton v. Arco Elecs., Inc., 188 A.2d 123, 125 (Del. 1963) (citing Langfedler v. Universal Lab'ys, 68 F. Supp. 209, 211 n.5 (D. Del. 1946)).

90. *Id.* at 125.

91. *See e.g.,* Terry v. Penn Cent. Corp., 668 F.2d 188, 188–90 (3d Cir. 1981).

92. *Id.* at 192–94.

93. Del. Code Ann. tit. 8, § 251(f) (2023). In turn the appraisal statute does not apply if the § 251(f) voting exception applies.

94. *Id.* § 262(b)(1).

95. *Id.*

being cashed out (in Delaware)[96] or if the transactions evidence a conflict (under the Model Business Corporation Act).[97] The most recent statutory constriction of appraisal was in a 2016 Delaware provision to dismiss appraisal claims for shares listed on a national securities exchange unless the claim involves more than 1 percent of entitled shares with a value of more than $1 million.[98]

The recent contracting out of appraisal discussed below thus occurs against a backdrop of broad statutory exclusions for appraisal. In addition, there have long been examples of specific contracting used to further minimize the likelihood of an appraisal claim. For example, merger agreements regularly have included conditions that, if more than a designated percentage of shares in the target company seek appraisal, the acquiring company can opt out of the merger after the shareholder vote.[99] Redeemable stock has also been used in connection with appraisal or buy-sell provisions.[100] In more complicated shareholder agreements referred to as "drag-alongs," a shareholder can be dragged along into the deal with no appraisal rights if specified conditions are met.[101] This can include a minimum price or the shareholders' receiving the same price as insiders or other conditions.[102]

Waivers of appraisal rights have generated recent litigation in Delaware. In *Halpin v. Riverstone National, Inc.*,[103] the Chancery Court declined to enforce a waiver where the language was unclear and the company had failed to follow procedures set out in the agreement.[104] Five years later in *Manti Holdings, LLC v. Authentix Acquisition Co., Inc.*,[105] the Delaware Supreme Court upheld a waiver by sophisticated

96. *Id.* § 262(b)(2).

97. Model Bus. Corp. Act § 13.02(b)(4) (Am. Bar Ass'n 2023).

98. 80 Del. Laws ch. 265, § 10 (2016) (codified as amended at Del. Code Ann. tit. 8, § 262(g) (2023)) (providing that a court shall dismiss appraisal proceedings for shares listed on a national securities exchange unless total number of shares entitled to appraisal exceeds 1 percent or the values of the shares entitled to appraisal exceeds $ 1 million).

99. Jill E. Fisch, *A Lesson from Startups: Contracting Out of Shareholder Appraisal*, 107 Iowa L. Rev. 941, 959 (2022).

100. *See* John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions,* 147 U. Pa. L. Rev. 1251, 1256 (1999).

101. Fisch, *supra* note 99, at 961–62.

102. *Id.*

103. No. 9796–VCG, 2015 WL 854724 (Del. Ch. Feb. 26, 2015).

104. *Id.* at *1.

105. 261 A.3d 1199 (Del. 2021).

and informed investors for consideration.[106] Both involved private companies. One involved preferred shares,[107] but the other suggested coverage of common shares.[108] In contrast, language of the Model Business Corporation Act suggests more limits on such waiver: the statute specifies permission for elimination of appraisal rights for preferred stock.[109] The official comment directly says that "[c]hapter 13 does not permit the corporation to eliminate or limit the appraisal rights of common shares."[110]

C. Startups Transitioning to Publicly Held Status

A third space of contracting out, somewhat different than the first two, has arisen in startups, such as those originating in Silicon Valley in recent decades.[111] These are entities that begin as private firms and use shareholder agreements to contract out of traditional governance rules, as in the closely held entities discussed in Subpart A. They differ from those entities in that their contracting sometimes carries forward into the governance for the entity once it has gone public.

Even during their time as private companies, these entities are different from traditional closely held entities. The relationship is not as intimate as in classic close corporations—i.e., among family members or close friends who decide to go into business together perhaps extending over their working lives. Nor is it the stranger-like relationship of individual investors buying into a large publicly traded corporation through mutual funds or some other large intermediary fund. These startup investors are often sophisticated investors looking to make larger investments.

Startup ventures also differ from classic closely held entities in that there is at least some market for the shares, which can provide more liquidity than in the typical closely held entity. It may not have the depth of markets provided by the NYSE or the Nasdaq market which can impact both liquidity and the degree of market monitoring in this kind of firm.

The use of contracting out during the private stage of these firms' existence is also likely to look different than traditional closely held firms, not so much as protecting particular employment or compensation decisions, but more sensitive to voting rights. A common focus of private ordering here is dual-class voting with more votes given to the

106. *Id.* at 1225–26.

107. *Manti Holdings*, 261 A.3d at 1220.

108. *Halpin*, 2015 WL 854724 at *1.

109. Model Bus. Corp. Act § 13.02(c) (Am. Bar Ass'n 2023).

110. *Id.* § 13.02 cmt. 3.

111. *See generally* Elizabeth Pollman, *Startup Governance*, 168 U. Pa. L. Rev. 155 (2019).

shares held by the founder to ensure the founder's initial voting control continues even when the initial public offering and other public financing reduces the founder's financial stake well below a majority.[112] The most likely conflict may well be between the shareholders who were there prior to the firm going public and those that entered later. These contracting out illustrations are more likely to carry forward and continue to govern fundamental-governance rights after the firm has gone public. Concerns have been raised that startup governance is less developed and less effective than governance for other firms that are going public.[113] Their governance has been described as "corporate adolescence" with attendant risks of excessive risk-taking and rule-breaking.[114]

Gabriel Rauterberg and Jill Fisch, each of whom have written important articles on elements of contracting out in the public-shareholder setting discussed earlier (Rauterberg co-authoring with Eric Talley on corporate opportunity,[115] and Fisch writing on appraisal),[116] have each also written on contracting out in startups, suggesting adaptations relevant for this new setting. Rauterberg's empirical data shows that 15 percent of corporations that went public in recent years did so subject to a shareholder agreement and that a carryover of such agreement can sometimes affect nonparty shareholders.[117] Fisch worries that utilizing shareholder agreements in this setting leads to "stealth governance" and can avoid traditional corporate governance accountability that comes from standardization and transparency in public governance.[118] She would limit contracting out to the articles and bylaws and limit use of shareholder agreements in this setting.[119]

112. Fisch & Davidoff Solomon, *supra* note 80, at 1064.

113. See for example in a discussion of unicorns, a visible example of startups, in Renee M. Jones, *The Unicorn Governance Trap*, 166 U. Pa. L. Rev. Online 165, 167–68 (2017) ("[I]n the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and practices appropriate for enterprises of their scale."). *See generally* Elizabeth Pollman, *Startup Governance*, 168 U. Pa. L. Rev. 155 (2019).

114. *See* Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 Tex. L. Rev. 1347, 1357 (2021).

115. *See generally* Rauterberg & Talley, *supra* note 61.

116. *See generally* Fisch, *supra* note 99.

117. Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 Yale J. Regul. 1124, 1129 (2021).

118. Fisch, *supra* note 99, at 945–53.

119. *Id.* at 954–56.

III. Mapping the Modern Space for Private Ordering and Contracting Out in Corporations

This Part seeks to understand the contracting out described in Part II in each of these still-developing contexts. Two questions shape this pursuit: What should be the space for contracting out in today's business environment? And what limits should be recognized? Subpart A identifies several macro influences that have pushed society toward more private ordering and permissible contracting out in corporate law. Subpart B focuses on the particular characteristics evident in the three areas discussed in this Article relevant to the two questions. Subpart C develops where we should expect limits to remain in this space.

A. Macro Influences on the Shift in the Societal View to More Private Ordering and Contracting Out

Even when sovereigns kept strict control on chartering of entities, there was a recognition of the effectiveness of ceding greater power to private actors. In the British and Dutch East Indies Companies, sovereigns gave private entities broad autonomy over foreign trade ventures, and perhaps more importantly the companies gained some protection against the sovereign's sudden removal of private control.[120] Dari-Mattiacci, Gelderblom, Jonker, and Perotti effectively show how limits on the government expropriation of private assets were a necessary precondition to the development of a corporation with the indicia of separateness that we associate with the modern corporation and how the Dutch and then the British were first able to achieve this in the seventeenth century.[121] Elizabeth Pollman has shown how a parallel development of protection from removal of self-governance developed for corporations in America as the nineteenth century unfolded.[122]

This corporate illustration of private ordering and contracting out is part of a much larger and long-running societal debate over the relative power of government and freedoms left to individuals, which has ebbed and flowed over centuries. Supreme Court Justice Stephen Field described the broad remit of American corporations of the late nineteenth century:

120. Giuseppe Dari-Mattiacci, Oscar Gelderblom, Joost Jonker & Enrico C. Perotti, *The Emergence of the Corporate Form*, 33 J. L. Econ. & Org. 193, 195–96 (2017).

121. *Id.* at 195–97.

122. Pollman, *supra* note 20, at 1741 ("[L]ike capital lock-in or asset partitioning, constitutional protection under the Contract Clause added to the stability of the business enterprise by enabling the corporation to make credible commitments and helping to ensure that firm-specific investments would be protected.").

> A large proportion of our people are members of some corporation,—religious, educational, scientific, trading manufacturing, or commercial . . . . [Their] aggregate wealth . . . amounts to billions upon billions of dollars . . . and furnishes employment, comforts, and luxuries to all classes, and thus promotes civilization and progress . . . .[123]

By that point, as Morton Horwitz has noted, there had been "stunning reversal in American economic thought" to "defend and justify as inevitable the emergence of large-scale corporate concentration."[124] For some, this belief led to a conclusion that "legal forms cannot interfere with the natural evolution of the economy," expressed in support of general incorporation acts that did not restrict corporations.[125] The enabling approach to state corporate law described in Part I appeared at this point.[126] Led by New Jersey in the 1890s and soon replicated elsewhere, states abandoned their traditional regulatory approach to corporations in favor of enabling statutes that no longer restricted these entities.[127]

For progressives of the day, the same economic fact of the inevitability of bigness led to more support for intense federal regulation that found expression in antitrust and railroad regulation from the late nineteenth century, or the Tillman Act of 1907[128] that banned corporate political contributions,[129] or the tax laws of 1936 subjecting corporations to a less favorable tax.[130] This federal oversight intensified in the new regulatory state instituted by the New Deal with a particular attention

123. Cnty. of Santa Clara v. S. Pac. R.R. Co., 18 F. 395, 404–05 (C.C.D. Cal. 1883).

124. Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. Va. L. Rev. 173, 190 (1985).

125. *Id.* at 196.

126. *See supra* notes 22 & 23 and accompanying text.

127. Professor Joel Seligman termed it a "revolution wrought in the law of corporations" that "turned corporate law inside out." Seligman, *supra* note 23, at 264, 273. Professor (later Supreme Court Justice) Wiley Rutledge described this period as "destined eventually not only to reverse the historic policy of the states toward corporations, but to place state policy . . . fundamentally in opposition to that of the Federal Government." Rutledge, Jr., *supra* note 23, at 307.

128. Ch. 420, 34 Stat. 864 (repealed and recodified as amended at 52 U.S.C. § 30118(a)).

129. 52 U.S.C. § 30118(a).

130. Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 Wm. & Mary L. Rev. 167, 229 (2002) (describing enactment of the 1936 act and the first full double taxation of corporate income).

to the new and growing power of corporations and the need for social control over their broad power.[131] The reality is that the corporate world on the ground in the nineteenth century produced two distinct streams of law in response to the rise of the large corporation: state laissez-faire corporations law that today's corporate bar would still recognize as familiar, and a distinctively more regulatory federal law that has continued to grow over more than a century.[132]

By the 1970s and 1980s, there was a visible shift back toward more reliance on individuals and private actors. This shift was visible in corporate law as well as illustrated by a conference of corporate law scholars gathering at Columbia Law School in 1988.[133] On one side was Professor Mel Eisenberg, author of the leading corporations casebook of the day and chief reporter for an American Law Institute project on corporate governance that reflected the prevailing governance view of the time: mandatory rules should govern core fiduciary and structural areas where interests of shareholders may diverge.[134] At the conference he faced a direct and blunt attack from Fred McChesney, part of the new wave of contractarians seeking to reshape corporate governance.[135] McChesney challenged Eisenberg's efforts as seeking to compare a governmental regime that is assumed to be perfect and costless with imperfect contractual arrangements as they actually exist. In McChesney's view, Eisenberg's paradigm "stack[ed] the . . . deck in the coercionists' favor."[136] There was electricity (and some tension) in the room that day.[137] The debate continued with rebuttals and surrebuttals

131. *See, e.g.*, Sherman Anti-Trust Act of 1890, ch. 647, 26 Stat. 209 (codified as amended at 15 U.S.C. §§ 1–7) (prohibiting activities that restrict interstate commerce and competition in the marketplace); Interstate Commerce Act of 1887, ch. 104, 24 Stat. 379 (repealed and recodified as amended at 49 U.S.C. § 11501) (requiring railroad rates to be "reasonable and just").

132. *See* Robert B. Thompson, *Why New Corporate Law Arises: Implications for the Twenty-First Century*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? 3, 4–10 (Steven Davidoff Solomon & Randall Stuart Thomas eds., 2019).

133. *See* John C. Coffee, Jr., Joseph A. Grundfest, Roberta Romano & Murray L. Weidenbaum, *Corporate Takeovers: Who Wins; Who Loses; Who Should Regulate?*, REGUL.: AM. ENTER. INST. J. ON GOV'T & SOC'Y, Winter 1988, at 23, 28.

134. Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1480 (1989).

135. *See generally* Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530 (1989).

136. *Id.* at 1531.

137. In the views of this observer, a then-recently tenured corporate law professor.

in law review issues.[138] The broader debate over the scope of private ordering and contracting out in modern corporate law likewise reflects the current state of societal thinking about this broader question.

A third broader theme that has influenced contracting out in corporate law is a longer-term evolution in approaching conflicts of interest. Over time, there has been a very noticeable change in corporate law's approach to conflict of interest moving generally in the direction of greater acceptance of conflict and a greater willingness to embrace a wider array of private actions to deal with conflict than had previously existed. In 1880, for example, Justice Stephen Field took a more traditional view of conflict:

> The law . . . will always condemn the transactions of a party on his own behalf . . . . Directors of corporations, and all persons who stand in a fiduciary relation to other parties, and are clothed with power to act for them, are subject to this rule . . . .[139]

This right to nullify (as either void or voidable unless it were fair)[140] continued through much of the twentieth century. But over time, cognizant of a "potentially harsh result" from the loss of "potentially beneficial transactions simply because of director self-interest,"[141] states shifted to statues that provided safe harbors based on action by disinterested directors or shareholders to cleanse the taint of self-dealing. California's 1977 statute was influential here,[142] as were the 1988 changes to the Model Business Corporation Act.[143] Over time, Delaware case law has broadened to recognize that a special litigation committee can provide the necessary director cleansing and has expanded the requirements provided for such cleansing.[144] This law, for example, requires that directors be both disinterested and independent

138. *See generally* Melvin Aron Eisenberg, *Contractarianism Without Contracts: A Response to Professor McChesney*, 90 Colum. L. Rev. 1321 (1990); Fred S. McChesney, *Contractarianism Without Contracts? Yet Another Critique of Eisenberg*, 90 Colum. L. Rev. 1332 (1990).

139. Wardell v. R.R. Co., 103 U.S. 651, 658 (1880).

140. *See* Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378, 380 (N.Y. 1918) ("A trustee may not cling to contracts thus won, unless their terms are fair and just.").

141. Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 745 (Del. Ch. 2007).

142. Act effective Jan. 1, 1977, ch. 682, 1975 Cal. Stat. 1538 (codified as amended at Cal. Corp. Code § 310 (2014)).

143. Frank R. Morris, Jr., *Changes in the Model Business Corporation Act—Amendments Pertaining to Directors' Conflicting Interest Transactions*, 44 Bus. Law. 1307, 1307 (1988); *see* Model Bus. Corp. Act §§ 8.60–8.63 (Am. Bar Ass'n 2023).

144. Aronson v. Lewis, 473 A.2d 805, 813–14 (Del. 1984).

of the interested party,[145] that shareholders making the cleansing decision be limited only to the disinterested shareholders,[146] and if the effort to cleanse goes to an action by a controlling shareholder, that the cleansing include an ab initio commitment to only doing the deal if obtaining both approval by the board and the shareholders meeting the applicable standards.[147] As illustrated in these contexts, such long-existing but substantive shifts in the cannon of governance views can be expected to have an impact on specific examples of contracting out discussed here.

B. Factors Affecting Contracting Out in Modern Corporate Cases

Corporate law has evolved to a point where contracting out is sometimes permitted and sometimes not. The three contexts examined in Part II identify situations where private ordering is increasingly accepted by law. The three specific contexts covered in Part II illustrate recurring themes that can affect the decision to defer to private ordering. Key are several determinants.

1. Customization of Governance Rules to the Needs of a Specific Business

As has long been true in closely held businesses, the law will trust private ordering in entities where the parties to a contract make up all the affected parties, so there is little risk of externalization. The same can be said of startups. The expertise of those close to the business and the ability of the key participants to bargain among themselves often provide a sufficient reason to suggest deference. The parties may well want to customize the rules affecting their governance given the particular business setting, and they may well want to innovate given their particular business. This deference is particularly powerful when the mandatory rules that the law would apply were in fact designed for an entirely different setting; the corporate rules of permanence, no liquidity, and centralized control best fit public entities, but work much less effectively when there is intimacy between the parties and no liquidity.

There is reason, however, to be more concerned about shareholder agreements decided only by the initial shareholders, which will protect their position after they have shifted to public financing. The initial market for shares could price such a risk, but experience in the modern initial public offering market suggest significant gaps.

145. *See, e.g.*, *In re* The Ltd., Inc. S'holders Litig., No. CIV.A 17148-NC, 2002 WL 537692, at *3–7 (Del. Ch. Mar. 27, 2002).

146. *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 & n.19 (Del. Ch. 2005).

147. Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644, 646 (Del. 2014).

2. Risk of Externalization

Risk of externalization remains the most significant restraint on contracting out. Its presence continues to provide a justification for continuing mandatory rules. Piercing the corporate veil illustrates the law's continuing willingness to interfere with limited liability and assert partitioning at the core of modern separateness accorded to corporate entities. Parallel impacts on others serve as a reason for constraints on private ordering. In a public corporation where power is centralized and the capacity of dispersed shareholders to effectively use accountability and monitoring elements within the corporate form is reduced, there is reason to limit private ordering that removes more of the traditional restraints.

3. Limits on the Parties' Capacity in Publicly Held Companies to Sufficiently Address Agency Costs

There are two illustrations of agency costs in which contracting out has been a recurring concern. The first is in publicly held corporations where corporate law rules let directors make all corporate decisions while providing shareholders limited rights to vote, sell, and sue, each in limited doses. In a public corporation where shareholders are in the thousands and spread across the country/world with limited capacity to act collectively, there are sufficient reasons to stick with mandatory statutory norms to constrain director action. To the extent that there has been a change in capacity for shareholders to act collectively, as discussed below, the space for contracting out may change. The second illustration of agency costs is in the closely held firm where parties may fail to take advantage of proximity to the levers of corporate power because of failure to anticipate what future unraveling may occur. Sometimes, the parties may anticipate such concerns but stifle raising them because of a concern it would destroy the trust necessary to make a small business work. Cost, too, may block raising or resolving these concerns at the front end when the new business needs resources. A counterargument can be an example of a situation in which private ordering may be preferable because the legal rule is expensive, takes a long time, and can be replicated more cheaply or efficiently by private ordering.

4. Technology and Market Innovations that Change the Relative Capacity of Key Governance Players

Technology and market innovations are perhaps the biggest change in the contracting-out equation in modern times, particularly in the public company setting, with some spillover to the startups that carry forward their private governance into a public setting. The last three or four decades have ushered in an era of market and technological innovations that have greatly changed the traditional governance structure and the capacity of the players to contract out:

- It is cheaper to gather and store information about a business and the overall markets. There are more tools available to ordinary investors to help them evaluate their investments.[148]
- Typical shareholding in American public companies have moved from individual mom-and-pop investors, each holding small stakes and spread across the country, to intermediary funds assembling the investments of thousands into centralized funds.[149] These intermediary funds, in part prodded by the government to vote the shares they hold for others, have developed new strategies of governance.[150] Proxy advisory firms have arisen to efficiently provide advice to these intermediary funds as to how to respond to the thousands of votes they need to cast each year.[151] Activists' funds have arisen to search out opportunities where shareholders can make a difference and then work to bring the intermediary funds to a more activist governance role.[152] The large intermediary funds, not always, but sometimes, are willing to use their voting power to support some proposals.[153] As Rauterberg and Talley have said, this has ushered in an era of new structures to mediate corporate governance that have put new pressure on the

148. *See, e.g.*, Seth C. Oranburg, *A Little Birdie Said: How Twitter Is Disrupting Shareholder Activism*, 20 Fordham J. Corp. & Fin. L. 695, 707 (2015) ("Activists can now access virtually all shareholders and influence public opinion through social networks, relatively unencumbered by reporting requirements under SEC rules.").

149. *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. Rev. 721, 725–27 (2019).

150. *See* Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. Cal. L. Rev. 1359, 1395–96 & nn.154–55 (2014).

151. *See* Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 Emory L.J. 869, 870–72 (2010).

152. Remus Valsan, *Social Media and Shareholder Activism*, The Univ. of Edinburgh: Edinburgh L. Sch.: The ECCLblog (May 8, 2014), https://www.pure.ed.ac.uk/ws/portalfiles/portal/17674629/Social_MediM_and_Shareholder_Activism.pdf [https://perma.cc/MT9H-ARPQ] ("Activist shareholders use a variety of tools and channels to engage with the management and with their fellow share owners. Increasingly, they are turning to electronic platforms, such as Twitter, LinkedIn, YouTube, blogs or dedicated electronic forums.").

153. *See e.g.* Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, N.Y. Times (June 9, 2021), https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html [https://perma.cc/5F2W-6QV7] (detailing Engine No. 1's successful effort to elect three directors at Exxon supported by institutional investors).

existing cannon of dealing with governance, including contracting out.[154]

- These new technologies and market structures have also empowered governance mechanisms at the board level. There are more specialized players at the board level.[155] More accessible data and market information has made director marketing more viable and made it easier for funds and outside investors to interject governance proposals.[156]
- A final innovation that has been important to governance has been the greater ability of investors in non-public companies to have some liquidity.[157] While not extending to the smallest closely held entities, companies are now able to stay private longer and still meet their needs to grow, thus increasing the opportunity for more private ordering in this space.

C. The Mandatory Rules that Can Be Expected to Remain

The technological and market changes described in the previous Subpart provide several reasons why it is not surprising that there has been a growth of private ordering. More information can be efficiently gathered and distributed with lower coordination costs, bringing more players into the governance game. This last Subpart addresses three areas where mandatory corporate rules can be expected to remain despite these changes.

1. Core Fiduciary Duties—Negating a "Purely Contractual" Law

The reasons for fiduciary duty and why they can't be easily waived have not dissipated. The acute vulnerability of a minority investor in a closely held entity after a fallout between the parties remains. The more recently developed Revised Uniform Limited Liability Company Act's rules are more rigorous than Delaware's LLC laws on letting fiduciary

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154. *See* Rauterberg & Talley, *supra* note 61, at 1103–04.

155. Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. Chi. L. Rev. 219, 247, 253 (2009) (noting that private equity firms have an incentive to hire industry-knowledgeable, financially sophisticated directors to increase portfolio value).

156. Such activist investors are willing to make multiple billion-dollar investments to pursue such a strategy. *See, e.g.*, Lauren Thomas & Laura Cooper, *Activist Takes Big Stake in Salesforce*, Wall St. J. (Jan. 22, 2023, 7:08 PM), https://www.wsj.com/articles/activist-takes-big-stake-in-salesforce-11674432531 [https://perma.cc/T2MB-JDLG].

157. Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 Cornell L. R. 1573, 1619 (2013).

duties be waived.[158] For public corporations, Delaware, the main lawmaker for public corporations law, doesn't permit core conflict duty-of-loyalty claims to be waived.[159] The need to preserve these bulwarks remains.

Vice Chancellor Travis Laster, in a pair of Chancery cases, has noted the description of LLCs "primarily" as "creatures of contract"[160] and has emphasized the importance of not reading past the adverb to get to a purely contractarian result:

> [T]he purely contractarian view discounts core attributes of the LLC that only the sovereign can authorize, such as its separate legal existence, potentially perpetual life, and limited liability for its members. *See* 6 *Del. C.* §§ 18–201, 18–303. To my mind, when a sovereign makes available an entity with attributes that contracting parties cannot grant themselves by agreement, the entity is not purely contractual. Because the entity has taken advantage of benefits that the sovereign has provided, the sovereign retains an interest in that entity. That interest in turn calls for preserving the ability of the sovereign's courts to oversee and, if necessary, dissolve the entity. Put more directly, an LLC agreement is not an exclusively private contract among its members precisely because the LLC has powers that only the State of Delaware can confer. Those powers affect the rights of third parties, who at a minimum must take into account the LLC's separate legal existence and its members' limited liability shield.[161]

The Vice Chancellor noted prior case laws that had relied on commentary to the effect that the Delaware LLC should be viewed as a purely contractual entity to which principles of equity (including fiduciary duty) do not apply[162] and recognized, as well, other

158. Unif. Ltd. Liab. Co. Act § 105(d)(3) (Unif. L. Comm'n 2013) (permitting altering or eliminating certain duties unless it is "manifestly unreasonable").

159. Del. Code Ann. tit. 8, § 102(b)(7) (2023).

160. Obeid v. Hogan, No. 1190-VCL, 2016 WL 3356851, at *5 & n.2 (Del. Ch. June 10, 2016).

161. *In re* Carlisle Etcetera, LLC, 114 A.3d 592, 605–06 (Del. Ch. 2015).

162. *See* R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 WL 3846318, at *4, *7 (Del. Ch. Aug. 19, 2008) (citing Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 5 (2007), and works by Professor Larry Ribstein, including Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. Ill. L. Rev. 131, 153-54 (2008) and Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 Va. L. & Bus. Rev. 35, 67 (2008)).

commentary undermining a purely contractarian approach.[163] He concluded: "Reasonable minds could disagree about that proposition. But whatever one's personal thoughts might have been on the matter, the General Assembly in 2013 adopted an amendment to the LLC Act inconsistent with the purely contractarian view."[164]

For public corporations, Delaware, the key American jurisdiction for the law in that space, protects the core fiduciary duty in a conflicts setting. Startups bringing forward private agreements likely will become a future ground to test this debate. The conflict in startups will be when the private ordering insulates a founder with control but leaves disproportional risk with new public investors creating a possible spillover impact on the larger economy. The degree to which contracting out of voting or fiduciary duty survives in the setting may depend on whether the public market adjusts, such as by lowering pricing for some new issuers with questionable accountability.

2. Greater Oversight of Cleansing

An earlier Subpart described the law's move away from considering conflicts void or voidable to permitting them with very robust cleansing mechanisms.[165] This move has the appearances of private ordering in that it makes use of corporate actors as the cleansers, but it would better be described as private ordering with heavy conditions that can make it seem like a mandatory rule. There must be full disclosure to the decision-maker, any special directors committee must be both disinterested and independent, and only shareholders who are also disinterested can qualify for the job.[166] In addition, if the conflict is particularly worrisome given corporate governance (i.e., there is a controlling shareholder who might overly influence the director or shareholder decision-makers), both cleansers are required. This private ordering with specific conditions reflects the continuing shadow of mandatory corporate law. It may be that the still-developing rules for private agreements in startups that carry forward into the public

163. *See* Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 Fordham J. Corp. & Fin. L. 445, 460–71 (2009) (identifying historical, jurisprudential, and policy reasons why LLCs should not be regarded as purely contractual entities); Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. Corp. L. 295, 315–24 (2014) (reviewing empirical studies and presenting data about alternative entity agreements that undermine premises of purely contractarian approach).

164. *In re* Carlisle Etcetera LLC, 114 A.3d 592, 605 (Del. Ch. 2015).

165. *See supra* Part III.A.

166. *See supra* note 145 & 146 and accompanying text.

setting make use of this kind of enhanced restrictions on private ordering.

3. Limitations on Contracting Arising from Contractual Interpretation

There is a third constraint on private ordering that has not received as much attention as the first two, but one which remains important in the contracting-out space. That is the continuing role of courts in interpreting contracts. This judicial task goes beyond corporate law rules to contract law. Thus, an Oregon court held: "We examine first the text of the disputed provisions in the context of the document as a whole. If the document's meaning is clear, our analysis typically ends."[167] If not, courts apply contract rules to resolve ambiguity, relying on maxims of contractual interpretation, for example, construing ambiguous provisions against the drafter, determining the more specific provisions control over the more general, and looking to extrinsic evidence.[168]

A Delaware decision illustrates the interaction of a contract and fiduciary duty. A company which had gone public and then quickly burned through all of the money generated in that deal reverted to financing from its founder, issuing him shares with 80,000 votes per share that provided the founder more than 70 percent of the vote with about 20 percent of the equity.[169] There was a three-person board of directors and the founder, as the majority voter, had a contractual right to remove any or all of the directors. After a lengthy period of financial deterioration, with the company facing insolvency and other board members viewing the founder as "the central problem," the other two directors called a special meeting to issue a new series of stock to a new investor who would gain control of the company. They did not tell the founder of their plan.[170] The Vice Chancellor held the founder had a right to advance notice of the plan to issue shares that would supplant his control and remove him from office. The court's focus was on the interference by the other two directors of the controlling shareholder's "exercising his or her contractual right to put a halt to the other directors' schemes."[171]

Another Delaware case resulted in a similar holding in an LLC context. Two investors (one with 75 percent and the other with 25 percent) had agreed on a three-member board of managers and that the

167. Patel v. Siddhi Hosp., LLC, 495 P.3d 693, 696 (Or. Ct. App. 2021).

168. *See* O'Neal, et al., *supra* note 33, at § 5:3.

169. Adlerstein v. Wertheimer, No. CIV.A. 19101, 2002 WL 205684, at *2 (Del. Ch. Jan. 25, 2002).

170. *Id.* at *4.

171. *Id.* at *9 & n.28.

75 percent unitholder could appoint, remove, and replace two of the three members.[172] As in the previous case, the minority member/manager was able to persuade the third manager that the founder must be ousted from leadership for the LLC to prosper. Many LLC employees and even some of the founder's lieutenants testified that they believed it to be in the LLC's best interest to take control from the founder.[173] The court noted that the agreement allowed a simple majority of the board to take actions such as the merger that diluted the majority, rather than rely on the statute, which would have required a majority vote of the equity interest, instead of the managers. The court said the two managers "intentionally used a flawed process" (i.e., their lack of notice—which was not required by the agreement) to block the majority's use of the provision to remove managers that would have protected "his interests in the manner contemplated by the very LLC Agreement under which they purported to act."[174]

This same interpretive process was used to protect one of two 50/50 members in another Delaware case. In *Fisk Ventures, LLC v. Segal*,[175] the founder had brought in another investor, and the LLC agreement required 75 percent approval to act and gave the incoming investor a put right to sell its interest to the entity after four years at a set price.[176] The lack of a tie-break led to five years of almost perpetual deadlock, including over whether to seek voluntary dissolution. The court found that the lack of a deadlock-resolving device in the agreement by "sophisticated and well represented parties" was not something the court could redraft, but that lack of contracting did not prevent the granting of involuntary dissolution by the court.[177] Each party had the right to attempt to maximize its position in accordance the LLC agreement's terms.[178]

Another example of a court's willingness to interpret the contract in light of the parties bargaining was *Obeid v. Hogan*, discussed earlier.[179] There the parties had adopted a corporate governance structure for their three-member LLC. When two of the three removed the third after the third complained of corporate opportunities said to be taken

172. VGS, Inc. v. Castiel, No. C.A. 17995, 2000 WL 1277372, at *1–2 (Del Ch. Aug. 31, 2000), *aff'd,* 781 A.2d 696 (Del. 2001).

173. *Id.* at *2.

174. *Id.* at *5.

175. Fisk Ventures, LLC v. Segal, No 3017-CC, 2009 WL 73957 (Del. Ch. Jan. 13, 2009) *aff'd*, 984 A.2d 124 (Del. 2009).

176. *Id.* at *1–2.

177. *Id.* at *7.

178. *Id.* at *6.

179. *See supra* note 160 and accompanying text.

by the other two, the third member brought a derivative suit alleging a breach of fiduciary duty.[180] When the other two sought to install a one-person special litigation committee to address the suit, the court applied existing Delaware precedent in the corporate space that prevented a one-person commercial committee.[181] The court found that the "corporate traits" of the contract call for applying corporate precedents to derivative claims involving the entity.[182] The court found the parties' agreement to choose the corporate trail essentially led to "enhanced scrutiny"[183] that has become an entrenched part of Delaware law for public corporations.

These cases show how contract interpretation works in tandem with traditional fiduciary duties in business entities. The result is likely to be continuing assertions of mandatory rules, even in the face of extended use of contracting in any of the three settings discussed in this Article.

Conclusion

The twenty-first century has already produced substantial changes in how contracting out is treated in corporations law. The new law of LLCs has expanded the space for private ordering in closely held entities, underlying a movement to increasing the deference to bargaining among the parties that has long recognized in close corporations. More dramatic has been the move to permitting contracting around common-law fiduciary duty in several contexts relating to public corporations. As the transition space for entities moving between private ownership and public ownership has grown in recent years, there have been a growing number of examples where participants have adopted exceptions to default governance structures while privately owned and then taken them forward to the entity in its publicly held persona. The changes reflect the capacity of parties to contract. But it does not remove the traditional application for mandatory legal rules, such as fiduciary duty, that will continue to be applied in corporate law.

180. Obeid v. Hogan, C.A. No. 11900-VCL, 2016 WL 3356851, at *2 (Del. Ch. June 10, 2016).

181. *Id.* at *19.

182. *Id.* at *8.

183. *Id.* at *13.