THE CALCULUS OF SHAREHOLDERS' CONSENT: A CONSTITUTIONAL ECONOMICS THEORY OF CORPORATE CHARTER AMENDMENT RULES

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ABSTRACT

The charter of a corporation is the "constitution" agreed to by all its members. The charter, however, is not a "suicide pact," it can be amended according to the charter amendment rules in corporate law when circumstances change. These charter amendment rules vary significantly across jurisdictions. In Delaware, shareholders can amend the charter with a simple majority vote of shares. The amendment must be initiated by the board of directors and decisions to amend the charter are made usually by a supermajority vote of shares. Board approval is not necessary in the United Kingdom, Germany, or France. Within a given jurisdiction, the rules governing the amendment of different provisions are also very different. This Article makes the first attempt to employ the constitutional economic theory developed by Buchanan and Tullock to explain different charter amendment rules. It identifies a fundamental tradeoff between the needs of *adaptation* and *commitment*. If charter amendment rules are too procedurally burdensome, they may harm the adaptation of corporate charters. If they do not impose meaningful regulation on charter amendment, minority shareholders cannot be sure that corporate insiders or controlling shareholders would not amend the charter in the

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midstream to harm shareholders' interests. Different states may choose different charter amendment rules to achieve a balance between *adaptation* and *commitment*. The choice between different charter amendment rules made by different states can be explained by several factors, including institutional investors and judicial capacity. This theory sheds new light on a series of issues in the corporate law literature, including the explanation for mandatory rules and appraisal rights in corporate law, the debate of increasing shareholder power in the United States, and why law, rather than contract, is important in corporate governance.

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INTRODUCTION

The charter of a corporation is the "constitution" of the corporation that sets out the "rules of the game." The charter, however, is not a "suicide pact," it is subject to amendment pursuant to the charter amendment rules when circumstances change.[1] A comparative study of the charter amendment rules in several major jurisdictions—the state of Delaware in the United States, the United Kingdom (U.K.), France, and Germany—shows that different jurisdictions have adopted very different charter amendment rules. For example, while the corporate law in Delaware mandates that only the board has the power to initiate an amendment to the corporate charter and a simple majority vote of shares is necessary to pass an amendment to corporate charters, a decision to amend the charter in the U.K. does not need board approval but must be approved by a three-fourths majority vote of shares.[2] Within a given jurisdiction, the amendment rules for different provisions in the corporate charter are also different—some provisions are subject to amendment by a majority or a supermajority vote of shares while others are mandatory rules that cannot be amended.

This Article endeavors to develop a theoretical framework to analyze the social costs associated with different charter amendment rules and to explain the variation of these rules both across and within jurisdictions. It argues that two goals that are usually in conflict need to be considered in choosing the rules that govern the amendment of a corporate charter: *adaptability* and *commitment*.[3] A corporation may exist for a long time. When circumstances change, the corporate charter also needs to adapt. While all shareholders

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1 Different states use different terms to refer to the charters, including, for example, "certificate of incorporation" in the state of Delaware and "articles of associations" in the United Kingdom. *See* DEL. CODE. ANN. tit. 8, § 101(a) (2019), [https://perma.cc/H5RH-B5JA]; Companies Act 2006, c. 46, § 17 (Eng.) [https://perma.cc/B9WD-KJ7J. *See also* DEL. CODE. ANN. tit. 8, § 109 (2019) [https://perma.cc/H5RH-B5JA] (describing the requirements for adopting, amending, and appealing bylaws). The Delaware Corporate Code uses the term "charter" in a broad sense. It includes the bylaws that contain provisions that are relatively unimportant.

2 *See* DEL. CODE. ANN. tit. 8, § 242(b) (2019), [https://perma.cc/H5RH-B5JA]; Companies Act 2006, c. 46, § 283 (Eng.), [https://perma.cc/B9WD-KJ7J].

3 *See* Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 9 (2006) (discussing the costs and benefits of a charter that is difficult to amend versus a charter that is easy to amend).

agree to the corporate charter when they join the corporation, unanimous consent is usually not required when the charter is to be amended.[4] Requiring unanimous consent would negatively affect the charter's adaptability.[5] On the other hand, if the charter can be amended too easily, the unanimous consent given by the shareholders at the time when the charter was enacted becomes meaningless because a corporate insider can always change the "rules of the game" afterwards. If the corporate charter can be amended simply by a majority vote of shares without any further legal constraints, including fiduciary duty or mandatory rules in corporate law, corporate insiders or the shareholders controlling a majority of shares may amend the charters opportunistically. Expecting this problem *ex ante*, investors may then refrain from buying the shares in the corporations even if the corporate charters offer them strong protection of their rights at the time of their investment. This *commitment* problem would deter investment or at least raise the cost of outside capital when a corporation is established.

In economic terms, different charter amendment rules give rise to different levels of *decision-making costs* and *external costs*. Decision-making costs include the costs that shareholders incur in participating in collective decisions and the costs that arise because of the problem of holdout.[6] Shareholders participating in collective decisions need to spend time and resources in evaluating the decision, which impose a direct cost on them while the benefits are

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4 *See* DEL. CODE. ANN. tit. 8, § 242(b) (2019), [https://perma.cc/H5RH-B5JA]; Companies Act 2006, c. 46, § 283 (Eng.), [https://perma.cc/B9WD-KJ7J].

5 At a publicly held company, unanimity requires not just the consent of all shareholders, but all potential shareholders in the world, who could buy a single share to block the transaction. Shareholders may agree to a rule of supermajority vote, which requires a three fourths majority vote of share. Under this arrangement, shareholders holding more than a quarter of shares can block the amendment to the corporate charter. These shareholders may hold out the amendment to obtain more benefits. William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 79-82.

6 *See* JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT 98-99 (1962). Decision-making costs arise here because normally a bargaining range will exist, and, recognizing this, each individual will seek to secure the maximum gains possible for himself while keeping the net gains to his partners in the agreement to the minimum. Each individual will be led to try to conceal his own true preferences from the others in order to secure a greater share of the 'surplus' expected to be created from the choice being carried out.

to be shared by all shareholders. Thus, they may lack incentive to participate and choose to free-ride on the efforts of others. For those who participate, each shareholder has incentive to hold out the decision until he gains more from the bargain even though the amendment is in the interest of the corporation.[7] A high procedural threshold for amending a charter provision incurs relatively high decision-making costs, which affect the *adaptability* of a corporate charter because shareholders may be unable to approve an amendment that is beneficial to all shareholders. Meanwhile, external costs are the social costs that arise because corporate insiders or controlling shareholders may make an amendment that benefit themselves at the expense of shareholders as a group.[8] It results from the so-called "opportunistic amendment problem"—insiders of a corporation may amend the corporate charter to enhance their power or even entrench themselves after shareholders join the corporation, harming the interests of shareholders.[9] A low threshold for charter amendment gives rise to relatively high external costs, which may deter investment *ex ante* because of the insiders' inability to make a *commitment* to investors that they would not amend the charter in a way that harms shareholders.

Different charter amendment rules incur different degrees of external and decision-making costs. As the size of the vote required to approve an amendment increases and the procedural constraints on the amendment are tightened, decision-making costs rise while external costs decline.[10] This theory suggests that different provisions in a corporate charter should be subject to different amendment rules.[11] When the amendment involves provisions that are relatively trivial, shareholders may make an amendment decision by a simple majority vote or simply delegate the decision

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[7] *See* Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule*, 70 S. CAL. L. REV. 741, 751 (1997) ("In the case of a holdout, however, the securities holder who withholds her vote does so in order to reap an additional profit as a result of her support at a later, more critical stage.").

[8] BUCHANAN & TULLOCK, *supra* note 6, at 45-46.

[9] *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-75 (1989) (discussing the benefits of eliminating opportunistic amendment through mandatory rules).

[10] *See* BUCHANAN & TULLOCK, *supra* note 6, at 74 (making a similar argument in considering the economics of constitution). *See also infra* Section 1.2. (discussing these issues in greater detail).

[11] *Id.* at 73 ("All potential governmental or collective activity should not be organized through the operation of the same decision-making rule.").

to the board of directors. For more important provisions, shareholders may set a supermajority rule, for example, a three fourths majority rule, for amending these provisions. When it comes to the amendment of provisions that fundamentally alter shareholders' rights, shareholders should choose a unanimity rule, in which case shareholders cannot amend these provisions without unanimous consent of all shareholders, or a mandatory rule, which prevents the charter provision from being amended.

The theoretical framework of external and decision-making costs explains why different states have adopted different charter amendment rules.[12] Corporate laws in different jurisdictions need to achieve a different balance between external costs and decision-making costs. In jurisdictions where external costs are the major concern, corporate laws are likely to set up a high threshold for charter amendment.[13] Where external costs can be effectively controlled by other mechanisms and decision-making costs are the major concern, corporate laws may adopt a relatively low threshold for charter amendment.[14] This Article identifies two major factors that may affect the magnitudes of external costs and decision-making costs in a given state: institutional investors and judicial capacity. Given the different roles played by institutional investors and the different capacity of courts in different states, the same charter amendment rule may incur different levels of external and decision-making costs, rendering the same rule efficient in some states but not in others.

For example, the three fourths majority rule in the U.K. can be explained by the fact that decision-making costs for shareholder voting are relatively lower than other major jurisdictions because institutional investors play an active role in corporate governance in the U.K. and the free-rider problem is less severe.[15] A second

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[12] While scholars have long noticed this difference, current theories have failed to provide an adequate explanation. For example, the widely accepted distinction between civil law and common law does not explain the drastic difference between the law in U.K. and the state of Delaware. Rock et al. mentioned the differences but did not offer any explanation. Edward Rock et al., *Fundamental Changes*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, 186-87, 222-24 (2009) (explaining possible alternative structural explanations for the difference between U.K. and Delaware corporation laws).

[13] See *infra* Section 2.1.

[14] See *infra* Section 2.1.

[15] See *infra* Section 2.1.

example might be the state of Delaware. The simple majority rule adopted in the state of Delaware can be explained by the fact that courts in Delaware are highly capable of detecting opportunistic actions and play a major role in protecting shareholders from opportunistic amendment decisions initiated by corporate insiders.[16] Thus, external costs are relatively unimportant for corporations in Delaware. The bilateral veto regime in Delaware could be viewed as an effort to reduce decision-making costs compared to the supermajority rule by lowering the threshold for shareholder approval and delegating the power to the board of directors.

The theoretical framework of external and decision-making costs also provides a new explanation for mandatory rules in corporate law, which has long been a subject of academic interest.[17] Currently, the most influential theory about mandatory rules in corporate law is the "opportunistic amendment hypothesis" proposed by Jeffrey Gordon.[18] Corporate insiders or controlling shareholders may amend the charter in the midstream to enhance

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16 See *infra* Section 2.1.

17 See *infra* Section 2.2.

18 Gordon, *supra* note 9 at 1573 (arguing that mandatory law provides insurance against opportunistic amendments that take advantage of incomplete corporate contracts). This "opportunistic amendment" problem has been recognized as a major justification for mandatory rules in corporate law. Roberta Romano, *Answering the Wrong Question: the Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1606 (1989) (questioning the validity of the "opportunistic amendment" problem as an explanation for the mechanics of corporate law); Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 566 (1990) (analyzing that charter amendments may increase shareholder wealth without maximizing it because managers seek their own benefits from such amendments); Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, COLUM. L. REV. 1395, 1401 (1989) (suggesting possible alternative procedures to implement charter amendments). *See also* Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1461(1989) (arguing that there are certain constitutive rules, including distributional rules, structural rules, and fiduciary rules, that should be made mandatory). The problems of shareholder voting in amending corporate charters also led many corporations to adopt the default rules offered by states. *See generally* Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1 (2006); Yair Listokin, *What do Corporate Default Rules and Menus do? An Empirical Examination*, 6 J. EMPIRICAL LEGAL STUDIES 279-308 (2009) (examining empirical evidence of the impact of corporate anti-takeover enabling statutes).

their power at the expense of outside shareholders.[19] This theory, however, cannot explain why corporations are allowed to adopt takeover defenses which may harm the interests of shareholders and benefit corporate insiders.[20] The theory in this Article suggests that the opportunistic amendment hypothesis is incomplete because it focuses entirely on external costs and ignores the associated decision-making costs.[21] Although mandatory rules eliminate the danger of opportunistic amendment, they harm the adaptability of corporate charters and thus incur decision-making costs.[22] Still, mandatory rules are not always in the best interests of outside shareholders faced with an opportunistic amendment problem.[23] This theory can better explain why mandatory rules vary across jurisdictions, and over time, the factors that affect the external costs and decision-making costs change.

This theory also explains the procedural requirements imposed on the exercise of appraisal rights and why the appraisal remedy has played a more important role in the United States.[24] Scholars have noticed that in many jurisdictions, corporate law imposes strict procedures on the exercise of appraisal rights, which is usually costly for the dissenting shareholders.[25] In addition, the valuation

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[19] Shareholders generally do not have fiduciary duty towards the corporation and can maximize their own welfare. *See* J.A.C. Hetherington, *Defining the Scope of Controlling Shareholder's Fiduciary Responsibilities*, 22 WAKE FOREST L. REV., 9, 12 (1987) ("Finally, the initial burden of fiduciary obligations rests on corporate officials…Shareholders, on the other hand, have traditionally been said to owe no fiduciary obligations to each other").

[20] Romano, *supra* note 18, at 1606 (" [T]here are no mandatory laws preventing such activity[the adoption of takeover defenses].").

[21] See *infra* Section 2.2.

[22] See *infra* Section 2.2.

[23] See *infra* Section 2.2.

[24] For examples of current studies, see Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 237-38 (1962) (explaining the mechanisms used to exercise appraisal remedies); Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV., 239, 243-45 (1999) (describing the theories surrounding the role of appraisal); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 11-12 (1995) (tracing the historical flux of appraisal in business).

[25] *See* Manning *supra* note 24, (describing the respective bargaining position of dissenting shareholders); *see also Elliott* J. Weiss; Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to Changes in Corporate Law*, 75 CALIF. L. REV. 551, 596 (1987) ("The procedural complexity and the cost of seeking appraisal, combined with the courts' use of valuation methods that

of the fair value of stocks is often uncertain and unpredictable, determined on a case-by-case basis by courts with careful consideration of the wrongdoings of the majority shareholders.[26] This Article suggests that the goal of the appraisal remedy is not simply to protect the interests of the minority but also to achieve a balance between external and decision-making costs.[27] If the exercise of appraisal remedy becomes costless for dissenting shareholders, many dissenting shareholders may employ this remedy to hold out corporate changes that benefit shareholders as a whole to extract private benefits. This Article suggests that these

provided most dissenting shareholders with scant hope of obtaining satisfactory relief, made appraisal a 'remedy of desperation.'"). For earlier discussion, see Comment, *The Doctrine of Strict Priority in Corporate Recapitalization*, 54 YALE L.J. 840, 845 (1945) (listing the weaknesses associated with appraisal rights); Note, *Appraisal of Corporate Dissenters' Shares: Apportioning the Proceeding's Financial Burdens*, 60 YALE L.J. 337, 340-343 (1951) (specifying the financial burdens associated with appraisal proceedings that frustrate their compensatory purpose); Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, HARV. L. REV. 1820, 1854 (1989) (explaining the effect of appraisals on manager decision-making); Note, *Interplay of Rights of Stockholders Dissenting from Sale of Corporate Assets*, 58 COLUM. L. REV. 251, 254 (1958):

> Appraisal supposedly protects the stockholder from any monetary loss which he would sustain by submission to the dictates of the majority. There is, however, criticism of its efficacy, based on the realization that the appraised value of the stock is not always its real or full worth. Since it is probably impossible to derive any method which would always be accurate in arriving at a value fair to all, the availability of relief other than appraisal is often of utmost importance.

26 *See* Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, DUKE L.J. 680, fn. 339 (showing that courts often reach appraisal values far greater than those offered by corporations); *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989) (upholding a higher appraisal value than proposed by the corporation); *In re Radiology Assocs., Inc.*, 611 A.2d 485 (Del. Ch. 1991) (awarding a larger appraisal value to the plaintiff after court evaluation of appraisal methods); *Neal v. Alabama By-Products Corp.*, No. CIV.A.8282, 1990 WL 109243, at *1 (Del. Ch. Aug. 1, 1990) (assigning a higher value for shareholders than initially offered by the corporation). In other jurisdictions, the application of appraisal rights also depends on a case-by-case basis. *See* Alan K. Koh, *Appraising Japan's Appraisal Remedy*, 62 AM. J. COMP. L. 417, 434 (2014) (outlining alternative methods for appraisal used in corporations in Japan); Hideki Kanda, Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 433 (1985) ("it is designed to accomplish the 'discovery goal,' explained in Part I as essentially a goal allowing shareholders to use the appraisal remedy to uncover possible managerial misbehavior.").

27 James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right,* 77 HARV. L. REV. 1189, 1216-17 (1964) (stating that, appraisal rights need to balance "the relative dangers of oppression by the majority and harassment by the minority.").

procedural burdens and uncertainty might be necessary in balancing these two costs and that proposals to alleviate the burdens on dissenting shareholders in exercising their appraisal rights may not always be socially desirable.[28]

The above theory also has important implications on the debate of increasing shareholder power in the United States. Currently, some scholars argue that the bilateral veto regime generates a bias towards the status quo that benefits managers of the corporation at the expense of shareholders' interests.[29] Others disagree and point out that delegating power to the board of directors benefits shareholders.[30] This Article provides a new perspective to this debate. The bilateral veto regime offers additional protection to shareholders by setting up an additional barrier of approval by the board of directors.[31] If, for example, the state of Delaware shifts to a unitary veto regime and allows shareholders to initiate charter amendment with a simple majority vote of share, decision-making costs would be reduced because shareholders can now make amendments with fewer procedural constraints but external costs may rise. Shareholders individually or collectively holding a majority of shares may adopt provisions in the corporate charter that benefit them at the expense of other shareholders.[32] Thus, the power

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28 Many scholars believe that the procedural costs imposed on dissenting shareholders in the exercise of appraisal rights should be alleviated. *See, e.g.*, Wertheimer, *supra* note 26 at 708; Robert B. Thompson, *Squeeze-Out Mergers and the New Appraisal Remedy*, 62 WASH. U. L. Q. 415, 432 (1984) ("The Delaware court has carved out an ambitious goal for the appraisal process; but appraisal may not be able to protect the minority without legislative changes."); Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 831 (1984) ("This Article begins by analyzing the basic defects in current state appraisal proceedings: the stock market exception, the methods of valuation, and the procedures and costs.").

29 Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 862 (2004).

30 Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 1739 (2002); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 791 (2017).

31 BUCHANAN & TULLOCK, *supra* note 6, at 233; ROBERT D. COOTER, THE STRATEGIC CONSTITUTION 187 (2000).

32 Consider a hostile takeover for example. A bilateral veto regime requires the approval of both the board of directors and shareholders. Thus, when a hostile acquirer obtains a majority voting rights, it still cannot approve a merger transaction without the support of the board of directors. Such a bilateral veto

of the board of directors should be viewed together with the simple majority rule in Delaware and any proposal to change the current rule needs to consider both external and decision-making costs.

Another fundamental question in the academic literature of corporate law is to what extent law is important in corporate governance. If a corporation is merely a "nexus of contracts," why are shareholders unable to decide all the terms in a corporate charter?[33] Current studies have not fully analyzed this question from a comparative law perspective.[34] This Article argues that law plays a larger role in corporate governance in some jurisdictions

regime enhances the difficulty of a merger and may prevent a hostile acquirer from passing a resolution of merger that does not benefit all shareholders and increases the premium that target shareholders can obtain. If a unilateral veto regime is adopted, a hostile acquirer may easily obtain control of a corporation and approve a merger transaction that may not benefit shareholders as a whole. *See* John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1175 (1984) (arguing that the benefit of auction contests depends on whether the ex post or ex ante perspective is used for analysis); Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981). The Delaware Court usually allows the board of directors to adopt takeover defenses in hostile takeovers to promote shareholder welfare as long as the defenses meet the *Unocal* test. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) (upholding a selective exchange offer that protects the substantial value of minority shareholder value). *See also Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (2011) (affirming a board offer as adequate in price and not structurally coercive). Recent studies have shown that a staggered board enhances shareholder welfare. K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 80 (2016).

33 The contractarian view is famously proposed by Frank Easterbrook and Daniel Fischel. Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 698-737 (1982); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 395-427 (1983).

34 Current studies have not provided a full account of why mandatory rules vary across countries. John Coffee first argued that the balance between enabling and mandatory rules shifts over time and varies across jurisdictions, depending on the competence of the judicial system. John C. Coffee, Jr., *Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1620 (1989). Moreover, as this Article will show, while John Coffee is certainly correct that judicial capacity will affect mandatory rules, other factors, including for example, the presence of institutional investors, may also potentially affect the level of mandatory rules in corporate law. After John Coffee pointed out the importance of a comparative perspective, few studies have explored the mandatory rules in various jurisdictions. Although there are a few scholars who consider different options to shareholder protection from a comparative law perspective, their analysis is not focused on charter amendment. *See, e.g.*, Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUDIES 17, 17 (2007) (explaining an EU Commission proposal to harmonize shareholder rights).

while contract plays a larger role in other jurisdictions. Whether law or contract plays a dominant role depends on the relative strength of different institutions.[35] Where shareholders can vote with relatively low decision-making costs and where legislative and litigation costs are high, it is more efficient for shareholders to make their own "contract" at will.[36] Where courts and legislatures are sophisticated, however, law can protect the interests of shareholders at lower costs.[37] Corporations can then delegate the tasks of charter amendment to the state legislature and courts,[38] which may reduce the external costs and decision-making costs associated with shareholder voting. Viewing judicial intervention this way deepens our understanding of the role of corporate law in corporate governance.[39]

This Article proceeds as follows. Section 1 develops a constitutional economic theory of corporate charter amendment rules. It argues that different charter amendment rules incur different levels of external and decision-making costs. It also identifies the major factors that affect the magnitude of these costs in different jurisdictions. Section 2 applies this theory to explaining the variation in charter amendment rules across jurisdictions, including the state of Delaware, the U.K., Germany and France, and providing a new account of mandatory rules and appraisal rights in corporate law. Section 3 considers the policy implications of this theory on the design of mandatory rules in corporate law, especially in emerging economies, and the implications on theoretical debates about increasing shareholder power and the role of law in corporate governance.

1. A CONSTITUTIONAL ECONOMIC THEORY FOR CORPORATE CHARTER AMENDMENT

A corporate charter is the constitution of the corporation, which lays out the rules governing the corporate decision-making process.

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35 See *infra* Section 3.3.

36 See *infra* Section 3.3.

37 See *infra* Section 3.3.

38 Hansmann, *supra* note 3, at 9.

39 Some scholars argue that corporate law is trivial, and corporations can always select their desired level of corporate governance. Black, *supra* note 18.

When shareholders invest in a corporation, they all agree to a corporate charter. However, circumstances may arise that demand the corporate charter be amended. The constitutional economic theory, developed by Buchanan, has been successful in explaining constitution and constitutional amendment. The theory also helps analyze the social costs of different charter amendment rules in corporate law.

1.1. An Economic Theory of Constitution and Constitutional Amendment

A corporate charter is often referred to as the constitution of a corporation.[40] Similar to the constitution of a state, a corporate charter contains rules governing different decisions of a corporation.[41] Buchanan and Tullock famously developed a constitutional economic theory about the design of constitutional rules.[42] They argue that in devising a constitution, individuals submit certain activities to be collectively decided while leaving others in the private realm.[43] In making such decisions, members need to consider two costs—external costs and decision-making costs.

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40 Corporate charters can better be termed "corporate constitutions" rather than "corporate contracts," since the amendment of a contract needs consent of all parties to a contract, but a constitution does not need a unanimous vote to be amended. As scholars have long noticed, corporate law and constitutional law share many similarities. *See, e.g.*, Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 377 (1988) (stating that the "parallels between economic and political associations are numerous enough to warrant a comparison.").

41 A corporate charter may include rules governing a related-party transaction, the issuance of stocks, and procedures of a shareholder meeting.

42 *See* BUCHANAN & TULLOCK, *supra* note 6.

43 BUCHANAN & TULLOCK, *supra* note 6, at 45. *See also* STEPHEN HOLMES, PASSIONS AND CONSTRAINT: ON THE THEORY OF LIBERAL DEMOCRACY 173 (Univ. of Chicago Press 1995) ("A liberal constitutional framework is a classic solution to a collective action problem. People may voluntarily relinquish their ability to choose (in some matters) in order to accomplish their will (in other matters). Collective self-binding can therefore be an instrument of collective self-rule.").

External costs arise because some members may dictate a decision that benefits them at the expense of the dissenters.[44] Since certain decisions are made by other members of the collective, each individual loses part of the control over the decision and thus becomes potentially subject to the tyranny of the majority. Some of the members may thus make a decision benefiting themselves even though the decision harms all members as a whole.

Collective decision-making also incurs decision-making costs, both direct and indirect.[45] Participating in the collective decision necessarily incurs time and expenses, which impose direct costs on members in a charter amendment process.[46] In addition, collective decision-making may give rise to indirect costs because of the problem of strategic voting. Members may vote based on how others behave rather than based on their true preferences. Specifically, members may strategically holdout in order to get more private benefits.[47] Consequently, decisions that benefit the state as a whole may be delayed or blocked, which adversely affect the welfare of all members of a state.

Suppose State A faces an invasion from State B, and suppose that the constitution of State A requires any declaration and action of war to be approved by a two-third majority vote of all citizens in that state. Such a constitutional rule is likely to incur significant decision-making costs—not only because each individual must undertake the costs and time to vote, but also because the vote may delay necessary action. Some citizens may even opportunistically holdout the decision by withholding their consent in order to extort personal benefits. Due to participation costs and the holdout

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44 BUCHANAN & TULLOCK, *supra* note 6, at 45 (External costs are "costs that the individual expects to endure as a result of the actions of others over which he has no direct control.").

45 BUCHANAN & TULLOCK, *supra* note 6, at 99 ("Each individual will be led to try to conceal his own true preferences from the others in order to secure a greater share of the 'surplus' expected to be created from the choice being carried out.").

46 BUCHANAN & TULLOCK, *supra* note 6, at 99:

> [L]ooking backward from a decision once made, everyone in the group will be able to see that he would have been better off had the investment in 'bargaining' not taken place at all provided an agreement could have been reached in some manner without bargaining . . . .One method of eliminating bargaining costs is to delegate decision-making authority to a single individual and agree to abide by the choices that he makes for the whole group.

47 Goshen, *supra* note 7, at 751.

problem, citizens of State A may take a long time to make a decision, during which time State B may have gained a strategic edge.[48]

The optimal design of constitutional rules would seek to minimize the sum of external and decision-making costs, which Buchanan and Tullock refer to as "interdependence costs."[49] According to Buchanan and Tullock, members of a state are likely to select different decision-making rules for different activities in designing a new constitution.[50] The magnitude of external costs significantly depends on the extent of impact the decision may have on each individual, while the magnitude of decision-making costs depends on the procedure and the voting rules for the decision.[51] For most legislative activities of governments, members are likely to choose a majority rule.[52] In considering the constitutional rules on more important issues such as property rights and human rights, however, individuals will likely require a supermajority or complete unanimity. As they foresee that collective actions will impose significant external costs on them, the reduction in external costs far outweighs the increase in decision-making costs caused by these rules.[53]

To illustrate, let us consider two decisions made by a state: to expropriate a piece of land and to enact a new environmental law. The expropriation of land affects the property rights of the landowner without the owner's consent. The external costs incurred by the owner are likely to be more significant compared to the external costs on a person who disagrees with the enactment of the new environmental law. Thus, even if a majority of the state legislators supports the expropriation of the private land, a state constitution is likely to impose additional requirements on the decision to prevent the "tyranny of the majority."[54] Meanwhile, a

[48] *Id.*

[49] BUCHANAN & TULLOCK, *supra* note 6, at 46.

[50] BUCHANAN & TULLOCK, *supra* note 6, at 73-74.

[51] *Id.*

[52] *Id.* at 313.

[53] *Id.* at 73-74.

[54] For example, the Fifth Amendment of the United States provides that "nor shall private property be taken for public use, without just compensation." U.S. CONST. AMEND. V. This taking clause applies to the states through the Fourteenth Amendment. Although courts in the United States have generally adopted a deferential standard of review of the exercise of the eminent domain power by legislatures, judicial review nonetheless enhances the costs of governments

legislative majority is likely to be sufficient for the enactment of a new environmental law given that such decision is likely to incur relatively low external costs on the dissenters.

The above analysis of the design of constitutional rules also applies to the rules governing constitutional amendment. A constitution contains rules that set out the conditions for making various decisions by a state. The rules governing the decision to amend a constitution is one of these decisions and thus is usually included in a constitution. From the perspective of a law and economic theory, the amendment of a constitution is a decision made by the state, which also incurs external and decision-making costs. For efficiency, rules governing the constitutional amendment process should be designed to minimize interdependency costs.

An important implication of the economic theory is that the amendment clause in a constitution should not be the only mechanism to amend the constitution. For example, the Constitution of the United States provides an amendment procedure in Article V, which states that "[t]he Congress, whenever two thirds of both houses shall deem it necessary, shall propose amendments to this Constitution."[55] This, however, is not the only way to amend the Constitution.[56] For example, the commerce clause in the Constitution of the United States had a very different meaning prior to and after the New Deal. Bruce Ackerman has documented how the United States changed its constitution with and without using Article V.[57] The theoretical framework of external and decision-making costs further suggests that the constitution of a state should

expropriating private property. *See, e.g.*, *Berman v. Parker*, 348 U.S. 26 (1954) (deciding in an 8-0 decision that the government may take private property under the 5th Amendment Takings Clause for a public purpose with just compensation); *Hawaii Housing Authority v. Midkiff* 467 U.S. 229, 241 (1984) ("one person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation be paid"); Thomas W. Merrill, *Economics of Public Use*, 72 CORNELL L. REV. 61, 63, 81 (1986) (the "courts, in setting the limits of eminent domain, should ensure that just compensation is paid and enforce the due process 'tax'—the legislative and constitutional requirements that push the administrative costs of eminent domain above the costs of market exchange in thick market settings.").

55 U.S. Const. art. V.

56 BRUCE ACKERMAN, WE THE PEOPLE, VOLUME 2: TRANSFORMATIONS 28, 29 (1998) (suggesting that the People can undertake decisions if they wish to revise their Constitution: "Normal Americans have a right to assert their constitutional will in politics without making this project their life's work.").

57 *See generally id.*

be amended by a variety of approaches in order to reduce the social costs involved in constitutional amendments. As Ackerman observes, a formalistic understanding of Article V would create two dangers—"false positives" and "false negatives": a constitutional amendment may not occur even when the People have spoken; or, a constitutional amendment may take place even when the People do not intend so.[58] For certain important provisions that involve the fundamental human rights and property interests of individuals, even a supermajority rule should not be able to amend them.[59] For trivial issues, however, going through the constitutional amendment process may sometimes be too burdensome, which hurts the adaptability of the constitution.[60] When only trivial issues are involved, a more convenient way to amend a constitution might be for courts to change the interpretation of the constitution.

An example is the constitutional amendment rule itself. Scholars have long recognized the importance of constitutional amendment rules. Akhil Amar argues that amendment rules "are of unsurpassed importance, for these rules define the conditions under which all other constitutional norms may be legally displaced."[61] The power of amendment is sometimes regarded as an "incident of sovereignty" since it is equivalent to the power of making a new constitution.[62] Ulrich Preuss also recognizes that the amending power "is necessary to preserve the flexibility and sustainability of the constitutional order, but it can destroy it by amending the constitution in an anti-constitutional tenor."[63] As a result, some scholars argue that the constitutional amendment rule should not be subject to the same constitutional amendment procedure as other rules contained in a constitution.[64]

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[58] *Id.* at 29.

[59] BUCHANAN & TULLOCK, *supra* note 6, at 73.

[60] BUCHANAN & TULLOCK, *supra* note 6, at 64.

[61] Akhil Reed Amar, *The Consent of the Governed: Constitutional Amendment outside Article V*, 94 COLUM. L. REV. 457, 461 (1994).

[62] Suber, Amendment, in The Philosophy of Law: An Encyclopedia 31, 32 (Christopher Berry Gray ed., 2013).

[63] Ulrich K. Preuss, *The Implications of "Eternity Clauses": The German Experience*, 44 ISR. L. REV. 429, 430 (2011).

[64] Frank I. Michelman, *Thirteen Easy Pieces*, 93 MICH. L. REV. 1297, 1303-1304, n. 27 (1995) ("[P]erhaps the idea of a constitution requires absolute entrenchment of an amendment rule, which in turn at least relatively entrenches everything else.").

1.2. Applying the Constitutional Economic Theory to Analyze Corporate Charter Amendment

While Buchanan and Tullock mainly address issues of constitutional law, they recognize that "the conclusions are generally applicable to a wide variety of collective institutions."[65] This Article makes the first attempt to apply this theory to study corporations.[66] One of the major functions of a corporation is to aggregate the wealth of many people so that they can conduct businesses that each individual shareholder cannot. Thus, investors must give up some control once they invest in a corporation. Meanwhile, shareholders will not completely forgo their control since corporate managers or controlling shareholders may abuse their power to benefit themselves rather than using the corporate resources to maximize shareholder welfare.

In fact, the theoretical framework developed by Buchanan and Tullock can better explain corporate law since the framework is based on a model in which an individual is "assumed to be motivated by a desire to further his own interest, to maximize his expected utility."[67] This assumption works well when it comes to decisions of shareholders. Although shareholders may be concerned with other values, most of them intend to further their own interests by obtaining investment returns.[68]

One may raise an important objection to the analogy between constitutional law and corporate law: when shareholders join a corporation, they actually consent, at least implicitly, to the

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[65] BUCHANAN & TULLOCK, *supra* note 6, at 119.

[66] BUCHANAN & TULLOCK, *supra* note 6, at 64. The similarities between a corporate constitution and a state constitution have long been recognized. *See, e.g.*, Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473-522 (2003); ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 140 (2008) ("Shareholders were seen as voters, boards of directors as elected representatives, proxy solicitations as election campaigns, corporate charters and bylaws as constitutions and amendments.").

[67] BUCHANAN & TULLOCK, *supra* note 6, at 119.

[68] While corporations also have other constituencies, such as employees, consumers, and creditors, they usually do not have a say in the corporate charters. Reinier Kraakman & Henry Hansmann, *The End of History for Corporate Law*, *in* CORPORATE GOVERNANCE 49-78 (2017). When we discuss constitutional law, however, a citizen may have other values.

corporate charter.[69] In contrast, actual consent is usually difficult to obtain in the context of the constitution of a state—one may be borne in a state without having a chance to consent to its constitution. However, in the context of corporate charter amendments, unanimous consent by all shareholders of a public corporation is also not possible in most circumstances.[70] Thus, the amendment of corporate charter faces the same problem as the problem of lacking actual unanimous consent in constitutional law. Courts and legislatures can no longer rely on the actual unanimous consent of shareholders due to the problem of holdout, but must "calculate" the consent of shareholders based on theoretical reasoning.[71] Since actual voting is tainted with opportunism and oppression, legislatures and courts must consider what the choice of shareholders would have been had they been put behind a "veil of ignorance" without knowing whether they are the controlling shareholder or the dissenting ones.[72] The framework developed by Buchanan and Tullock is thus important in analyzing the charter amendment rules.

Another objection to this analogy may be that while democracy assigns one vote to each citizen, shareholders holding a larger share in a corporation are assigned more voting rights than shareholders holding a smaller stake. This Article contends, however, that the constitutional economic theory developed by Buchanan and Tullock still applies to corporate voting. Shareholders with a larger stake in a corporation have a stronger incentive to participate in corporate governance since they can reap more benefits from good performance of the corporation.[73] Thus, their consent can better represent the interests of all shareholders compared to shareholders who only hold a tiny bit of shares. I will further illustrate this point in Section 2.

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69 Of course, there are still limited circumstances in which an individual inherits the shares without actually agreeing to the charter of the corporation. In these cases, one can still more easily sell the shares than one can leave a state.

70 Most jurisdictions allow a corporation to amend the charter without unanimous vote. *See* DEL. CODE. ANN. tit. 8, § 242(b) (2019), [https://perma.cc/H5RH-B5JA]; Companies Act 2006, c. 46, § 283 (Eng.), [https://perma.cc/B9WD-KJ7J].

71 Hansmann, *supra* note 3, at 2.

72 BUCHANAN & TULLOCK, *supra* note 6, at 78.

73 Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 135 (1987).

1.3. Economic Analysis of Different Corporate Charter Amendment Rules within a Jurisdiction

Different rules governing the amendment of corporate charters also incur a different level of external costs and decision-making costs. The tradeoff between external and decision-making costs reflects the inevitable tradeoff between two needs—*commitment* and *adaptability*.[74] If corporation can easily make an amendment to its charter, external costs would be high because some shareholders may amend the charter when it does not benefit all shareholders. From an *ex ante* perspective, corporations may find it more difficult to raise equity funding since corporate insiders or controlling shareholders cannot make a credible commitment not to amend the rules in the midstream. If, however, the amendment to a charter is too difficult, decision-making costs are high. This prevents the charter from adapting to new circumstances when it benefits all shareholders, although it preserves the original commitment made by all shareholders.

Scholars have long identified an "opportunistic amendment problem" when a corporation amends its charter.[75] Corporate insiders have strong incentives to enhance their power by amending corporate charters at the expense of outside shareholders whose capital is "locked in."[76] Even if such amendments have been approved by shareholders, the approval may be tainted with coercion or conflicts of interests.[77] For example, a corporation can devise a "draconian" takeover defense that renders hostile takeovers realistically impossible. This would harm the interests of the shareholders while enabling management to entrench themselves.[78] If the threshold for charter amendment is set too low, the problem

[74] Ronald Gilson has made a similar distinction. See Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When do Institutions Matter?*, 74 WASH. U. L. Q. 327, 342 (1996).

[75] Gordon, *supra* note 9, at 1573.

[76] The major conflict in a charter amendment is between corporate insiders (managers and the controlling shareholder) and outside shareholders. *See* Rock et al., *supra* note 12, at 190.

[77] Eisenberg, *supra* note 18, at 1474.

[78] Delaware prohibits such defenses. *See, e.g.*, Unitrin, Inc. v. American General Corp. 651 A.2d 1384 (Del. 1995) (reversing the lower court's ruling because a company's hostile takeover should have been reviewed using enhanced scrutiny of its "draconian" actions); Unocal Corp., 493 A.2d at 956.

of opportunistic amendment may give rise to high external costs.[79] A high threshold can alleviate the danger that a part of the shareholders can amend the corporate charter to benefit themselves at the expense of all shareholders.[80]

Meanwhile, a corporation may exist for a long time.[81] Circumstances may change, resulting in the need to adjust the charter to reflect these changes.[82] A high threshold for charter amendment incurs high decision-making costs, including the direct costs of shareholders participating in the voting process and indirect costs of shareholders failing to approve an amendment beneficial to the corporation because of the problem of holdout.[83] Suppose that a corporation requires any amendment to its charter to be approved by unanimous vote of share. Each shareholder thus has a veto power for the amendment of a corporate charter. Each has an incentive to withhold its consent unless she receives some more personal benefits. If all shareholders adopt this strategy, the amendment would fail even when the amendment would benefit shareholders as a whole.[84]

Different charter amendment requirements, including a majority vote of share, a supermajority vote of share, a vote by disinterested shareholders, a unanimous vote, or mandatory rules, achieve a different balance between these two goals and are associated with a different level of external costs and decision-making costs.

1. Different shareholder voting rules—To illustrate the different external and decision-making costs associated with different charter amendment rules, let us first consider a supermajority rule. A supermajority rule sets up a barrier to shareholders or insiders hoping to opportunistically amend the corporate charter to enhance

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[79] BUCHANAN & TULLOCK, *supra* note 6, at 64.

[80] *Id.*

[81] Hansmann, *supra* note 3, at 1.

[82] Gilson, *supra* note 74, at 332.

[83] Goshen, *supra* note 7, at 751; BUCHANAN & TULLOCK, *supra* note 6, at 98 ("Decision-making costs arise here because normally a bargaining range will exist, and, recognizing this, each individual will seek to secure the maximum gains possible for himself while keeping the net gains to his partners in the agreement to the minimum.").

[84] *See* Goshen & Squire, *supra* note 30, at 791.

their power or strengthen their positions.[85] The difficulty of approving an amendment to the corporate charter depends on the threshold.[86] The higher the threshold for approval, the lower the external costs become.[87] If shareholders holding 99% of the shares of a corporation all agree to a merger transaction, the danger that such a transaction would cause harm to the rest of the shareholders becomes much smaller than in a case where only shareholders with 51% of the voting shares agree. The problem with raising the voting requirement, however, is the increase in decision-making costs—shareholders may also attempt to obtain more benefits by "holding up" the approval of amendment, even when such an amendment is beneficial for all shareholders. Thus, if the threshold for approving a proposal is set too high, many beneficial amendments may be thwarted.

It is also possible for shareholders to delegate the power to amend the corporate charter to shareholders holding less than 50% of shares. For example, a corporation may delegate the power to the board of directors[88] to amend its corporate charter. In that case, the controlling shareholder would have the ultimate say on the amendment. Moreover, in some jurisdictions, shareholders can choose to adopt a dual-class share structure—a class of shareholders can possess the control rights of the corporation while the other class of shareholders can only obtain financial interests.[89] Shareholders who purchase these non-voting shares essentially delegate the decision-making rights to those holding voting shares. These rules would incur higher external costs because the board or the shareholders may not always act in the best interests of all shareholders.[90] But it would probably incur relatively low decision-making costs.[91]

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[85] A majority or minority vote or a vote by disinterested shareholders can also raise the barrier for shareholder voting.

[86] A disinterested shareholder approval may also increase the difficulty of approving an amendment.

[87] BUCHANAN & TULLOCK, *supra* note 6, at 64.

[88] Whose members are mainly nominated and appointed by the controlling shareholder.

[89] Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 563 (2015).

[90] *Id.* at 566.

[91] BUCHANAN & TULLOCK, *supra* note 6, at 64.

For any given charter provision, as the size of the vote required to amend it increases, decision-making costs rise but external costs decline.[92] Decision-making costs are likely to rise at an increasing rate.[93] This is because as the size of the required vote increases, the market becomes "thinner," and the bargaining power of the remaining shareholders becomes stronger, leading to a more severe holdout problem. When shareholders adopt an unanimity rule, every single shareholder can thwart the decision, in which case the decision-making costs would be enormous.[94]

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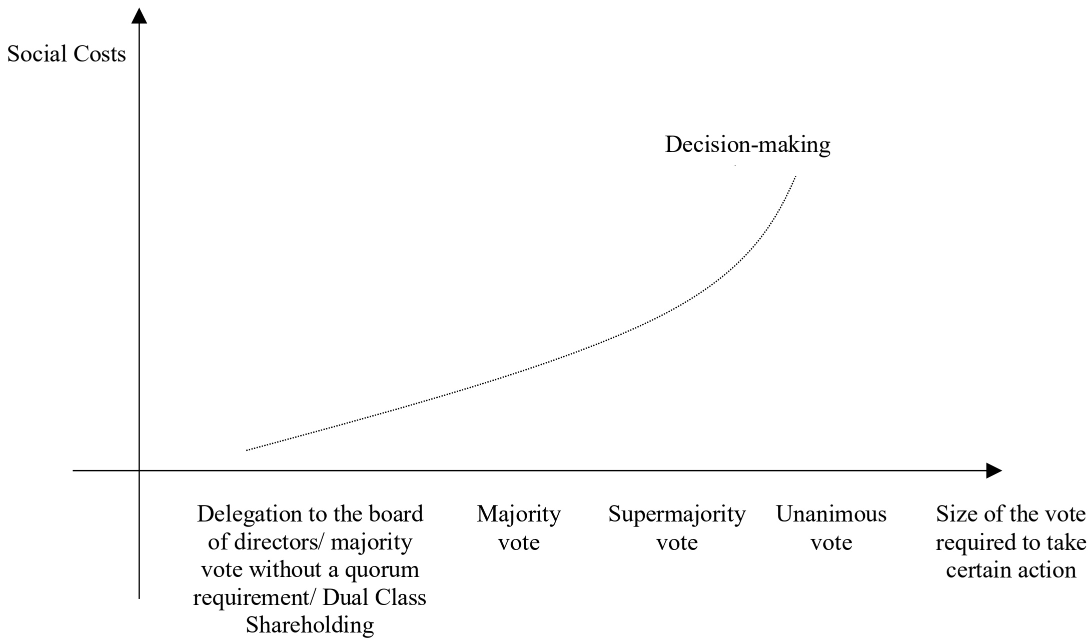
92 BUCHANAN & TULLOCK, *supra* note 6, at 64.

93 *Id*. at 68-69.

94 *Id*. at 60, 69.

Figure 1: Decision-Making Costs and the Size of the Vote Required for Charter Amendment



Meanwhile, external costs are likely to decline as the size of the vote required increases because if there are more shareholders approving the decision, it becomes more likely that the decision benefits all shareholders since they all have similar interests. When the decision requires a unanimous vote, the external costs become zero since each individual has the final say on whether the amendment should take place.[95] Efficient rules for charter amendment should thus minimize interdependency costs, i.e. the aggregate of decision-making costs and external costs.[96] Many corporations use a supermajority vote to amend their corporate charters because it achieves a balance between decision-making costs and external costs.[97]

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[95] *Id.* at 68.

[96] *Id.* at 62.

[97] This is similar to the analysis of decision-making rules in the design of a constitution. BUCHANAN & TULLOCK, *supra* note 6, at 68.

The above analysis suggests that a corporation should use different rules for the amendment of different provisions. For amendments that affect important interests of shareholders, shareholders are likely to choose a higher threshold. For trivial amendments, however, shareholders are likely to delegate the decision to the board of directors or use a simple majority vote. Consider, for example, the charter amendment rules in Delaware.[98] In Delaware, the amendment of a corporation's certificate of incorporation requires a majority vote while the authority to amend the bylaws, which contain provisions that are relatively less important, can be delegated to the board of directors.[99] Consider a trivial provision that stipulates the number of days that shareholders must be notified prior to a meeting. This provision does not affect the interests of shareholders significantly. If there is a sudden need for the corporation to change the period of notification, the decision-making costs of amending this provision would be too high if a majority vote is required. It may be more efficient to delegate the amendment decision to the board of directors. Although by delegating the decision to the board, shareholders risk incurring higher external costs—the board may not always act in the best interests of shareholders, the costs of doing so would be relatively low compared to, say, a decision to issue new stocks. Such a delegation is not likely to significantly raise external costs since the matter is trivial and the potential dissenting shareholders are not likely to suffer much loss. Thus, requiring the corporation to use a single amendment rule for amending these trivial provisions would be too costly. Meanwhile, there might be provisions that are so fundamental to shareholders that even a supermajority vote cannot duly protect minority shareholders, in which case a unanimous rule may be more appropriate.

2. *Mandatory Rules*—Apart from the shareholder voting rules discussed above, mandatory rules can also be viewed as charter amendment rules. By treating some rules in corporate law as mandatory, legislators prevent corporations from amending them with a majority vote or a supermajority vote of shares. Mandatory rules therefore incur much higher decision-making costs compared to a majority or a supermajority rule because mandatory rules

98 DEL. CODE. ANN. tit. 8, § 242(b)(1).

99 DEL. CODE. ANN. tit. 8, § 109(a).

prevent the charter from adapting to new circumstances. However, to the extent that legislatures seek to promote shareholder welfare and to curb the opportunistic amendment problem, mandatory rules lower external costs. When legislatures make certain rules mandatory, they may still be amended later when legislators amend the corporate statutes. Mandatory rules may incur lower decision-making costs compared to the rule of unanimity, which renders certain provisions almost impossible to amend when stocks are dispersedly held by public investors.

3. Fiduciary Duty and the Duty of Fairness—Courts may also impose mandatory rules on corporations by judicial review, on the grounds of fiduciary duty and the duty of fairness.[100] Fiduciary duty allows courts to interfere in the amendment of corporate charters *ex post* without specifying which rules are mandatory.[101] For example, the Delaware court has developed a set of case laws starting with *Unocal Corp. v. Mesa Petroleum Co.* that impose heightened standards of review on corporate decisions to adopt takeover defenses.[102] When an amendment does not involve a takeover defense, courts may still intervene on the ground of the duty of fairness.[103] Courts enjoy a certain advantage over legislators because they do not need to lay out bright line rules about what amendments are prohibited in advance and can intervene when they detect opportunism in the amendment decisions.

The social costs that arise from judicial review can also be analyzed using the framework of decision-making costs and external costs. By delegating the tasks of curbing opportunistic amendments to courts, shareholders may no longer need to require a supermajority vote to approve the amendment of a corporate charter, which significantly reduces the decision-making costs

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100 *See* Branson, *supra* note 40, n. 3. *See also* Douglas M. Branson, *Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53, 70-72 (1983) (listing the effects of fiduciary duties on a corporation).

101 Unocal Corp., 493 A.2d at 956; Unitrin, Inc., 651 A.2d at 1361.

102 Unocal Corp., 493 A.2d at 956; Unitrin, Inc., 651 A.2d at 1361.

103 *See* Gordon, *supra* note 9, at 1588; E. R. Latty, *Fairness. The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 2 (1942) (emphasizing fairness as the focal point in any discussion over the legality of "arrange elimination"); Kamena et al. v. Janssen Dairy Corporation, 133 N.J. Eq. 214, 31 A.2d 200, 217(1943) (weighing whether a corporation's proposed business plan "shocks the conscience" of the court).

because it alleviates the problem of holdout. A court can decide to permit an amendment and rule against the attempts by certain opportunistic shareholders to block the decision. When shareholders are too dispersed to assert their rights efficiently, courts may consider their interests and reject the amendments that are harmful to shareholders.[104] However, judicial review may also incur a certain level of decision-making costs—parties to a dispute need to go through the litigation procedure, incurring administrative and litigation costs.[105] Moreover, the external costs of this strategy depend on whether courts can successfully detect opportunistic conduct.

4. Combination of Strategies—It should be noted that the above analysis has not considered the possible combinations of different strategies. A common combination of charter amendment rules is to require the board of directors to initiate an amendment to a corporate charter before shareholders can vote on the decision, which creates a "bilateral veto"—an amendment that needs both the approval of the board of directors and a majority vote of shareholders.[106] This arrangement essentially imposes additional restrictions on charter amendment compared to a rule that only requires shareholder approval. It may increase the decision-making costs compared to a simple majority rule of shares—even when shareholders largely believe that an amendment is desirable, they cannot initiate it without the support of the board. Meanwhile, it may reduce external costs since it becomes more difficult for some shareholders to amend the charter.[107] However, compared to a supermajority rule, a "bilateral veto" may incur relatively lower decision-making costs since the number of directors is usually small, and they can act rather quickly with relatively low costs of decision making. But, delegating the power to the board rather than using a supermajority rule may incur the danger that some corporate insiders control the board and make decisions for their private benefits, incurring higher external costs compared to a supermajority rule.

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104 *See* Goshen & Squire, *supra* note 30.

105 *See e.g.* Roberta Romano, T*he Shareholder Suit: Litigation Without Foundation*, 7 J.L. ECON. & ORG. 55, 61 (1991) (discussing the costs involved in shareholder litigation).

106 See Rock et al., *supra* note 12, at 186.

107 BUCHANAN & TULLOCK, *supra* note 6, at 233; COOTER, *supra* note 31, at 187.

1.4. Economic Analysis of Charter Amendment Rules Across Jurisdictions

As illustrated above, different charter amendment rules are likely to incur different level of external costs and decision-making costs. The magnitudes of external costs and decision-making costs are likely affected by a set of factors that vary across jurisdictions. In some jurisdictions, curbing external costs is a more important goal for policymakers and public shareholders.[108] In others, external costs may be low, and decision-making costs become the major concern.[109] Identifying these factors may further enable us to explain charter amendment rules across jurisdictions.

1. Decision-Making Costs of Shareholder Voting—Let us first consider the decision-making costs incurred in shareholder voting. Decision-making costs include the direct costs that shareholders must bear in participating in the collective decision and the costs arising from the problem of holdout. Both of these costs are likely to be affected by the ownership structure of corporations and the presence or absence of institutional investors.

To illustrate, let us consider two hypothetical corporations. In corporation A, a controlling shareholder holds about 21% of the stocks, while a few institutional investors hold only 7% of the stocks, and the rest are held by individuals who do not participate in corporate governance. In corporation B, the institutional investors hold blocks of shares and have certain incentives to participate in corporate decision-making. The decision-making costs of a high threshold for charter amendment, say, a three-fourths supermajority vote of shareholders, is likely to be higher for corporation A than corporation B. Suppose that corporation A needs to amend its corporate charter to grant the board more authority in related party transactions, assuming these transactions are beneficial for the corporation. Given the free-rider problem, corporation A's shareholders do not have sufficient incentive to participate in corporate governance. In the shareholder meeting about the amendment decision, only the controlling shareholder and the institutional investors, holding in total 28% of the stocks of the

[108] *See infra* Section 2.1 for a detailed discussion of various jurisdictions.

[109] *See infra* Section 2.1 for a detailed discussion of various jurisdictions.

corporation, are present. The institutional investors who hold 7% of the stocks thus have *de facto* veto power over the amendment decision. They can act opportunistically by threatening to block the amendment unless the controlling shareholder agrees to give them personal benefits. Since they only hold a small proportion of shares, their incentive to approve the amendment is relatively small since they obtain only 7% of the benefits, while they may gain much more by holding up the decision. As a result, they may refuse to approve a charter amendment even when the amendment is beneficial for all shareholders.[110] In corporation B, by contrast, institutional investors may possess stronger incentives in studying or approving the amendment. Suppose institutional investors present in a shareholder meeting hold up to 80% of the stocks of the corporation. Assume that only institutional investors would participate in the shareholder meeting. Any institutional investors hoping to hold out the amendment decision would need to own at least 20% of the shares (a quarter of 80% of the stocks). If the amendment is not approved, the institutional investor is likely to suffer losses as well. The presence of active institutional investors significantly reduces decision-making costs because it alleviates both the direct costs and the problem of holdout.

2. Decision-Making Costs of Mandatory Rules and Judicial Review— The decision-making costs of mandatory rules also vary across jurisdictions.[111] Mandatory rules are only unamendable to the extent that legislators have not passed an amendment to the corporate law in a particular state. If a state frequently amends its mandatory rules, the decision-making costs may not be very high. Moreover, in some states, corporations can choose between different types of organizations, including for example, partnership, business trust, limited liability company, and a general business corporation. In these states, mandatory rules do not necessarily limit the

110 The institutional investor may overestimate the benefits for the controlling shareholder and demand significant benefits from the controlling shareholder, which the controlling shareholder may not be willing to provide. Consequently, the amendment may not take place. *See generally* Goshen, *supra* note 7.

111 In some jurisdictions, the decision-making costs of amending the corporate law are relatively high because corporate law is not considered as a priority in the political agenda. *See* BRYAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE, AND OPERATION (1997) 233.

autonomy of parties.[112] An entrepreneur hoping to raise money by issuing equity can thus signal her intention to credibly commit to a set of rules that cannot be changed.[113] Additionally, in a state with a federal system, corporations can also pick the state of incorporation, which allows them to select different sets of corporate constitutions. Each state has its own corporate law that contains a distinct level of mandatory rules. Entrepreneurs who hope to signal that they want to commit to a set of rules that cannot be changed afterwards can thus register in a state with tight mandatory rules. By contrast, in other states where there is only one set of corporate law, the decision-making costs of mandatory rules may be very high.

Another important factor that affects the magnitude of decision-making costs of mandatory rules by legislators is legislative costs. To amend a corporate statute, legislators would need to go through complex deliberation procedures, incurring significant administrative costs. Spending resources on amending a corporate statute also means that less attention would be devoted to other pressing issues. A crude proxy for measuring the legislative costs of amending a corporate statute is the frequency of the amendment of the statute. In the U.K., for example, scholars argue that company law is usually not given a high priority since it is apolitical.[114] As a result, company law is not frequently amended.[115] In China, a developing country, the Company Act was first enacted in 1993 and has only been amended twice so far, in 2005 and 2014, while the landscape of corporations in China has been changing drastically. The delay in amending the corporate law may negatively affect the adaptability of corporate charters if many provisions are mandatory.

The decision-making costs of judicial review depend on the efficiency of the legal system. In some states, resorting to litigation

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112 Romano, *supra* note 18, at 1600 ("Moreover, if a state has a particular payout restriction, such as a capital surplus requirement, which prevents a firm from paying out a dividend, it can reincorporate in a state that does not have the same rule").

113 Armour et al., *What is Corporate Law*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 22 (2nd ed., 2009).

114 *See* BRYAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE, AND OPERATION (1997) 233 (explaining the U.K. Parliament's limited ability to pass legislation and how that causes it to deprioritize matters that are not of immediate concern).

115 *Id.*

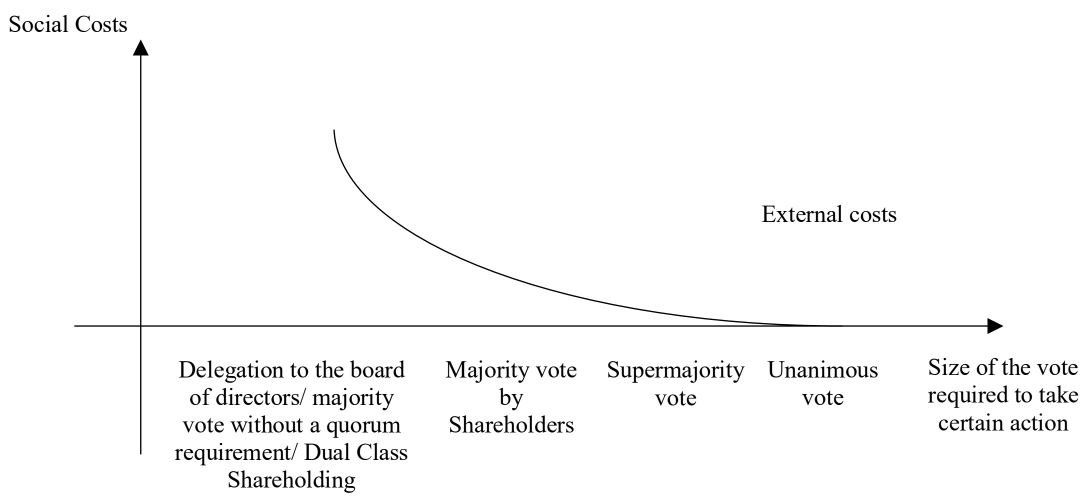
may be exceptionally costly for shareholders. Moreover, in states where class action is not allowed, each shareholder would tend to "free ride" on the efforts of others and would not initiate lawsuits against corporations even when the amendment of corporate charters harms their interests.

3. *External Costs of Shareholder Voting*—The magnitude of external costs incurred in shareholder voting also depends on several factors and varies across jurisdictions. Perhaps one of the most important factors is the ownership structure of the corporation. In a corporation, shareholders holding more shares are entitled to more voting rights, while each citizen in a state has only one vote. This is an important concern in considering the relationship between external costs and decision-making costs. If a corporation is held by a controlling shareholder who holds more than 50% of shares, a simple majority vote is likely to incur high external costs, compared to a corporation in which shares are dispersedly held. Majority shareholders can always amend the corporate charter in any way to further their own interests. Under such circumstances, a supermajority vote, or a majority of the minority vote, may significantly reduce external costs. Similarly, in a corporation with a controlling shareholder holding 90% of the shares, a three-fourths supermajority vote may not be able to significantly reduce external costs since it does not prevent opportunistic amendments initiated by the controlling shareholder.

The magnitude of external costs also depends on the idiosyncratic value each shareholder subjectively attaches to the rights conferred by a certain provision.[116] If shareholders all have similar goals, the consent of some members can serve as evidence that the rest of the shareholders would also agree if they were not trying to hold out the decision to obtain more personal benefits. Allowing the majority's consent to also bind the minority would impose lower external costs, as Figure 2 shows.

[116] BUCHANAN & TULLOCK, *supra* note 6, at 115 ("It seems reasonable to expect that more will be invested in bargaining in a group composed of members who have distinctly different external characteristics than in a group composed of roughly homogeneous members.").

Figure 2: External Costs and Size of the Vote Required (Low Idiosyncratic Value)



By contrast, if the amendment of certain provisions affects shareholders' interests in different ways, a majority or a supermajority vote becomes questionable. Figure 3 presents the curve of external costs, which remain largely steady as the size of the vote required to amend the charter increases and only drops steeply down to zero when a unanimity rule is reached. For example, in a merger transaction, some shareholders may have "inframarginal" value—they believe that the shares they own are worth more than the market price. Thus, shareholders may disagree as to whether the consideration in a merger transaction is adequate. Allowing shareholders with a majority of the voting shares to make the decision on behalf of all shareholders would mean that the shareholders who believe the stocks to be most valuable are coerced into selling their stocks. One may argue that the inframarginal value always exists because if shareholders did not believe the value of the stocks to be above the market price, they would have sold them already rather than holding on to them. In these cases, a supermajority rule with a high threshold may not significantly reduce external costs unless it reaches close to unanimity.

The factor of idiosyncratic value explains why corporate law generally imposes more constraints on classified shares and shareholders with different rights. In many jurisdictions, the amendment of corporate charters that affect the interests of one particular class of shares needs the approval of shareholders of that class.[117] Meanwhile, the creation of unequal shareholder rights is sometimes prohibited by the "one share, one vote" principle in some jurisdictions.[118] Even in jurisdictions where it is allowed, corporate law may require a higher threshold of shareholder voting.[119] When shareholders are treated differently, their interests may significantly diverge. A majority or a supermajority vote by all shareholders may not adequately protect the interests of the dissenting shareholders.

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[117] *See, e.g.*, Companies Act 2006, c. 46, § 633 (U.K.) (providing that when an amendment varies the rights attached to a class of shares, a group of at least 15% of the holders of that class "may apply to the court to have the variation cancelled"); Aktiengesetz[AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL I at 1089, last amended by Art. 5 Amendment Act, May 10, 2016, BGBL I at 1142 (Ger.), [https://perma.cc/6X2K-C9JF] [hereinafter Stock Corporation Act (Ger.)] ("[A] resolution of the shareholders' meeting shall require a majority of not less than three fourths of the share capital represented at the passing of the resolution."); Kaisha-hō [Companies Act], Law No. 86 of 2005, art. 322 (providing that acts that are likely to adversely affect the class shareholders of any class of shares "shall not become effective unless a resolution is made at a Class Meeting constituted by the Class Shareholders of the shares of such class").

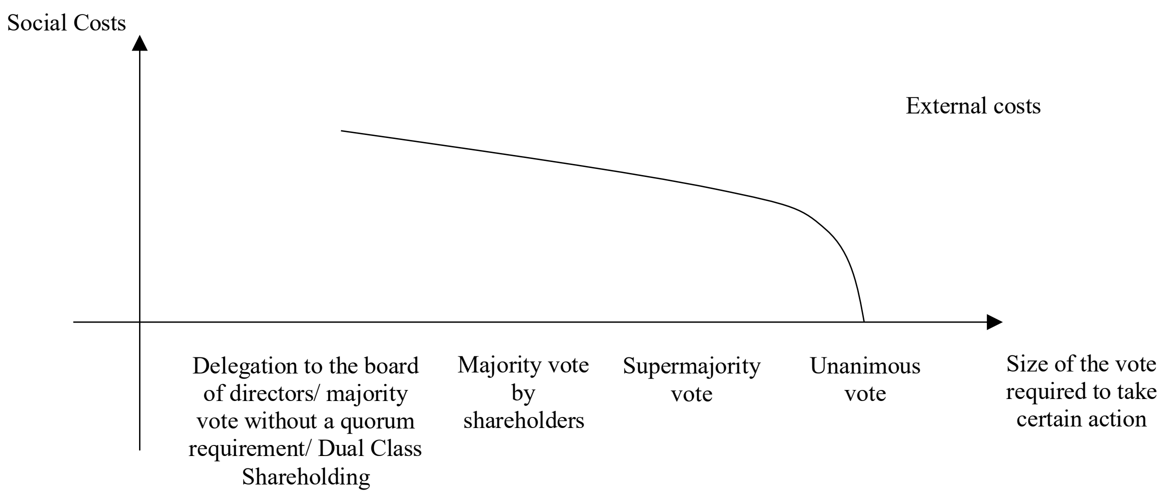
[118] *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 688 (1985) (discussing the NYSE's longstanding "one common share, one vote rule" and its history in the United States).

[119] For example, under Article 109(2) of the 2005 Companies Act of Japan, a non-public company can stipulate in its charter that shareholders be treated differently. Kaisha-hō [Companies Act], Law No. 86 of 2005, art. 109(2). However, pursuant to Article 309(4),

> resolutions of the shareholders meetings which effect any amendment in the articles of incorporation . . . with respect to the amendment in the articles of incorporation pursuant to the provisions of Article 109(2) shall be made by the majority . . . of all shareholders, being a majority equating three quarters (in cases where a higher proportion is provided for in the articles of incorporation, such proportion) or more of the votes of all shareholders.

Id. at 309(4).

Figure 3: External Costs and Size of the Vote Required (High Idiosyncratic Value)



4. External Costs of Mandatory Rules and Judicial Review—The magnitude of external costs incurred in using mandatory rules to curb the opportunistic amendment problem is affected by the political economy of the legislative process of corporate law in different states. For example, a statutory amendment may benefit managers rather than shareholders since dispersed shareholders suffer from the free-rider problem while managers can organize themselves to push for certain amendments to corporate statutes in the state.[120] Under these circumstances, delegating the task to state legislators to devise mandatory rules may still incur relatively high external costs. Similarly, although courts, securities regulators, and stock exchanges usually incur relatively low external costs because they are a relatively disinterested party, it is also possible that judges and regulators may be captured by corporate insiders who are economically and politically powerful, which may translate into high external costs.[121]

120 Black, *supra* note 18, at 568.

121 *See, e.g.*, G. William Schwert, *Public Regulation of National Securities Exchanges: A Test of the Capture Hypothesis*, 8 BELL J. ECON. 128 (1977).

The external costs incurred by delegating the decision to courts in the form of judicial review depend on the expertise of the court. In developed countries, courts are generally more sophisticated in making decisions on corporate law issues, but often the legal institutions are less developed in developing countries. Shareholders may also delegate the amendment decision to securities regulators and stock exchanges, which may help curb the opportunistic amendment of corporate charters.[122] Regulation by stock exchanges may impose certain pressure on listed corporations, deterring them from acting opportunistically against the interests of public shareholders.[123] Stock exchanges usually can react much faster than legislators and courts to respond to new problems. In developing countries where the judicial system is underdeveloped, stock exchanges may possess more expertise and thus play a larger role than courts and legislators.

2. EXPLAINING CHARTER AMENDMENT RULES

The above theoretical framework can be employed to explain several puzzles in the corporate law literature, including the variation of charter amendment rules in corporate law across jurisdiction, the mandatory rules that exist in corporate law, and the procedural burdens that are usually associated with the exercise of appraisal rights.

2.1. The Variation of Charter Amendment Rules Across Jurisdictions

1. The United States Approach — In the United States, Delaware is the most important state for the study of corporate law. The Delaware Corporate Code provides that the amendment of corporate charters must be initiated by the board of directors and approved by a "vote of the majority of shares present in person or

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122 *See generally* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

123 *See generally* Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929 (2008) (examining the distinct paths that stock market develops by tracing China's regulations of the stock market).

represented by proxy at the meeting and entitled to vote on the subject matter."[124] For some decisions, such as a merger or a sale of assets, Delaware law requires a majority of the outstanding shares.[125] A quorum consisting of no less than one third of the shares is required, although the certificate of incorporation or bylaws of the corporation can specify a higher quorum requirement.[126] Without the initiation of the board of directors, shareholders cannot approve any change to the corporate charter.[127] Other significant corporate changes such as merger and issuance of new shares also need to be initiated by the board of directors.[128] This "bilateral veto" regime is a unique characteristic of the law in Delaware, while board approval is not necessary in amending the charter in the U.K., Germany, and France.[129]

The above theoretical framework can explain the Delaware model. Let us first compare the Delaware bilateral veto model with a simple majority rule. The bilateral veto regime requires two levels of approval similar to the "bicameral legislature" design in the United States. This bilateral veto model incurs additional decision-making costs when compared to a simple majority rule that requires only a majority vote of shares by shareholders.[130] On the other hand, the bilateral veto regime may reduce external costs compared to a majority rule, since shareholders controlling above 51% of shares cannot initiate an amendment to the corporate charter without the boards' approval. This bilateral veto may be effective in protecting the minority shareholders against a hostile takeover.

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[124] DEL. CODE ANN. tit. 8, § 216(2) (2019). Although corporations are free to choose a supermajority vote, it is not mandatory. *See id.* § 242(b). In an anti-takeover context, a supermajority vote is sometimes employed as a "shark repellent;" a corporation may raise the size of the vote required to approve a merger in its charter, which cannot be amended unless by a supermajority vote. In this way, shareholders ensure that the provision is locked-in and cannot be amended easily by a hostile acquirer. *See* Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, *supra* note 74, at 790 (discussing how "lock-up amendments" can be used to deter unwanted takeovers).

[125] DEL. CODE ANN. tit. 8, § 251(c), 271(a), 275(b).

[126] DEL. CODE ANN. tit. 8, § 216.

[127] In Europe, the charter usually can be amended without initiation by the board. *See* Rock et al., *supra* note 12, at 186.

[128] DEL. CODE ANN. tit. 8, § 242.

[129] *See* Rock et al., *supra* note 12, at 186.

[130] *See* BUCHANAN & TULLOCK, *supra* note 6, at 233 (discussing the institution of the bicameral legislature in constitutional systems).

However, if the bilateral veto regime is compared, instead, to a supermajority rule that requires a three-fourths vote of shares, the bilateral veto regime may incur lower decision-making costs than the three-fourths system since directors in the bilateral veto regime could usually act with lower reliance on shareholders. That said, the bilateral veto regime would likely incur higher external costs than the supermajority rule since directors under the bilateral veto regime are selected only by a majority vote of shares. Thus, in bilateral veto regime, shareholders holding a majority of shares could have greater control of the board and may still harm the interests of the rest of the shareholders.

While some scholars worry about management entrenchment under the bilateral veto approach,[131] this Article suggests that the bilateral veto arrangement and the simple majority rule need to be considered together. The combination of these two strategies achieve a unique balance between decision-making costs and external costs. If Delaware did not require board initiation and, instead, adopted a simple majority rule, such a choice may raise external costs since some shareholders could more easily amend the corporate charter in their favor at the expense of all shareholders. This combined approach may also reduce decision-making costs and allow charters to adapt to new circumstances more easily.

The above theory can also explain the difference between charter amendment rules in Delaware and the supermajority rule adopted by many European countries. Although the bilateral veto regime adopted by Delaware incurs relatively high external costs compared with the supermajority rule, there exist alternative mechanisms to protect the interest of minority shareholders, thus alleviating the concern for external costs. One important mechanism is judicial review—courts impose a fiduciary duty on directors to ensure that these transactions will not harm the interests of shareholders.[132] Courts in Delaware are renowned for their expertise in corporate law and actively engage in resolving corporate charter amendment disputes.

An example may help illustrate the role of courts in charter amendment. Consider a corporation that decides to issue senior securities or eliminate existing rights by a board decision approved

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131 *See generally* Bebchuk, *supra* note 29.

132 *See* Rock et al., *supra* note 12, at 220.

by a majority vote cast by shareholders.[133] The Delaware courts frequently review such decision to see whether it meets the fiduciary duty. In an early case in 1936, *Keller v. Wilson & Co.*, shareholders with majority voting rights in a corporation decided to cancel the dividends accrued on its preferred stock.[134] The Delaware court invalidated the action on the ground that it violated the vested property rights of the holders of the corporation's preferred stock.[135] Although the vested property right doctrine was later discarded,[136] the Delaware court would still intervene to protect shareholders against unfair or inequitable treatment.[137] The Delaware law relied significantly on ex post legal intervention by courts rather than relying on ex ante legislation or shareholder voting to approve charter amendments. Courts also engage in decisions that involve the amendment of bylaws. In another Delaware case, *Blasius Industries, Inc. v. Atlas Corp.*,[138] a hostile acquirer, Blasius, proposed to the board of directors of Atlas to enlarge the board from eight to fifteen and to appoint another eight directors in order to seize control of Atlas. The board thwarted this attempt by amending the bylaws to add two more directors to the board, preventing Blasius from seizing control even if the shareholder's proposal were approved.[139] The court ruled that directors cannot interfere with shareholders' rights to vote unless there is a "compelling

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133 DEL. CODE ANN. tit. 8, § 242(b)(1).

134 *See* Keller v. Wilson & Co., 190 A. 115 (Del. 1936).

135 *Id.* at 125-26 ("It is one thing to confer a general power to accomplish a purpose in the future. It is quite another thing to say that the power may be exercised to destroy a right accrued and recognized as a vested right of property.").

136 *See* Branson, *supra* note 40, n. 81; *see, e.g.*, Bove v. Community Hotel Corp., 105 R.I. 36, 44 (1969) ("Delaware [has] discarded 'vested rights' as the test for determining the power of a corporation to eliminate a shareholder's right to preferred stock dividend accumulation[. . . .]").

137 *See* Latty, *supra* note 103, at 1 (arguing that fairness should be the focal point in discussing the legality of particular corporate decisions); *Kamena et al. v. Janssen Dairy Corporation*, 133 N.J. Eq. at 217-18:

> If such a plan is inequitable to the extent that it shocks the conscience of the court, this court then has the right as well as the duty to enjoin its consummation. It is more a question of fair dealing between the strong and the weak than it is a question of percentages or proportions of the votes favoring the plan.

138 *See* Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651 (Del.Ch. 1988).

139 *Id.* at 655. Delaware law allows shareholders to delegate the amendment of the bylaws to the board of directors. *See also* DEL. CODE ANN. tit. 8, § 109.

justification."[140] This case demonstrates that although Delaware law allows corporations to delegate authority to the board to amend the bylaws, the court can intervene to ensure that such power is not abused.[141]

The efficient legal system in Delaware also prevents holdout from happening even though corporate insiders can easily amend the articles of incorporation and the bylaws.[142] If the courts are capable of detecting holdout, the threshold of shareholder voting to approve an amendment decision can be lowered to reduce decision-making costs without the danger of raising external costs to a high level.[143] These factors might explain why legislators designed a lenient rule in Delaware after weighing the consent of shareholders.

The above theoretical framework of external costs and decision-making costs also explains the seemingly "inconsistent" arrangement whereby shareholders are allowed to initiate changes to the bylaws, which contain "second-order rules," while they cannot initiate changes to the charter provisions, which are the "first-order rules"—an arrangement Bebchuk refers to as a puzzle.[144] The theory proposed in this Article suggests that board initiation should be viewed as an additional barrier to the opportunistic amendment of corporate charter rather than a limitation on shareholders' rights. Thus, the current law is reasonable since the amendment to the corporate charter requires two steps—board approval and shareholder approval, while amendment to the bylaws requires the approval of only one of the corporate organs.

To sum up, for the state of Delaware, using a bilateral veto rule may significantly lower decision-making costs compared to the

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[140] *See Blasius Indus. Inc.*, 564 A.2d at 661.

[141] Scholars have noted that corporate rules in Delaware are "probably the least regulatory of states." Eisenberg, *supra* note 18, at 1482.

[142] In Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437 (Del. 1971), the bylaws allowed directors to move the date of the shareholder meeting. Directors of the corporation moved the date of the shareholder meeting in order to make it more difficult for shareholders to attend and to replace directors. The court banned such a move on the ground that it violated the shareholders' franchise.

[143] Professor John Coffee Jr., in considering the tradeoff between ex ante bright line prohibitions and ex post judicial review, argues that courts in the United States tolerate contractual freedom because of their ability to detect opportunistic actions. I believe, however, the tradeoff between the second-party and the third-party approach deserves more attention. Coffee, Jr., *supra* note 34, at 1620. The U.K. courts may not be as sophisticated as the Delaware courts. CHEFFINS, *supra* note 111, at 309.

[144] *See* Bebchuk, *supra* note 29, at 846.

supermajority rule. Additionally, the bilateral veto rule may not increase external costs compared to a supermajority rule as initially considered, since alternative mechanisms such as fiduciary duty enforced by courts offer additional protection for shareholders. Therefore, the bilateral veto rule may be efficient in the state of Delaware compared to a supermajority rule. While some scholars in the United States argue that a board-centered corporate governance structure incurs agency costs and have called for empowering shareholders, [145] a supermajority rule may incur significant decision-making costs significant enough to render it an inefficient or less efficient approach.[146]

2. *The U.K. Approach*—By comparison, under the Companies Act of the U.K., a resolution to amend the corporate charter needs to be passed by a three-fourths majority.[147] If a corporation seeks a variation of the rights of a class of shares, the shareholders must vote as a separate class. The U.K. law has also set forth a quorum requirement for such decisions.[148] Section 334(4) provides that under these circumstances, "two persons present holding at least one-third in nominal value of the issued shares of the class in question (excluding any shares of that class held as treasury shares)" need to be present in most meetings.[149] These rules suggest that the U.K. law has set a higher threshold for the amendment of corporate charters. Apart from the amendment of charter provisions, the U.K. law also sets a 75% threshold for mergers, which is higher than Delaware requires. Corporations listed on the market in London also need to gain shareholder approval for transactions of corporate

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145 *See generally id.* (arguing that, by allowing shareholders to adopt charter amendments, corporate governance would improve).

146 *See* Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 30, at 1755 (expressing skepticism toward Bebchuk's argument that increasing shareholder power will improve corporate governance).

147 U.K. companies can pass a written resolution by a majority of not less than 75% of the total voting rights of eligible members. They can also pass a resolution on a show of hands by not less than 75% of the persons who actually vote at the meeting. They can also pass a resolution on a poll taken at a meeting "by members representing not less than 75% of the total voting rights of the members who (being entitled to do so) vote in person, by proxy, or in advance on the resolution." Companies Act 2006, c. 46, *supra* note 1, § 283 (Eng.).

148 *Id.* § 630(4).

149 *Id.* § 334(4).

assets reaching a certain size.[150] Existing shareholders also enjoy preemptive rights and can purchase new shares pro rata before shares are issued to outsiders.[151]

The U.K. model can be termed a "shareholder-centered model" since the amendment of corporate charters significantly relies on shareholder approval. Two factors may explain the U.K.'s high threshold for amendments to corporate charters First, courts in the U.K. are less sophisticated than their counterparts in Delaware and lack the expertise in dealing with corporate law issues.[152] As a result, external costs in the U.K. may be higher since courts may not be able to detect wrongdoing by corporate insiders or controlling shareholders.

Second, institutional investors in the U.K. are active participants in corporate governance.[153] Studies have shown that institutional investors in the U.K. hold a higher percentage of shares than their counterparts in the United States.[154] This makes it easier for the

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150 Financial Conduct Authority, 43 Listing Rules 10.1.3 (2019), [https://perma.cc/3WP8-XWEU]. *See also* Rock et al., *supra* note 12, at 221.

151 Companies Act 2006, c. 46, *supra* note 1, § 560-77 (Eng.), [https://perma.cc/B9WD-KJ7J]. By contrast, in the United States, the default rule is that shareholders do not have preemptive rights. Scholars have noted that the preemptive rights may delay the issuance of new shares and raise decision-making costs. *See* Rock et al., *supra* note 12, at 196.

152 *See* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 431 (2003) ("The vast majority of judges [in the U.K.] lack any expertise with the realities of the corporate world.").

153 *See* Paul L. Davies & Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 AM. J. COMP. L. 301, 366-67 (2013) (analyzing the active function of corporate boards in several European Countries); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2002 (1994) (explaining the role of financial institutions in corporate governance in the U.K.). In recent years, however, the equity shares held by institutional investors in the U.K. have gradually declined, replaced by more foreign institutional investors. A survey in 2008 showed that most publicly traded stocks in the U.K. were held by foreign investors (42%). Brian R. Cheffins, *The Stewardship Code's Achilles' Heel*, 73 MOD. L. REV. 1004, 1018 (2010) (highlighting that many of the foreign investors are still institutional investors). Domestic institutional investors held about 30%,while individuals held about 10%. *Id. See also* BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 390 (2008) (breaking down the change in owner ship, from 1993 to 2006, of shares in publicly traded U.K. companies).

154 *See, e.g.*, John Armour, Brian R. Cheffins & David A. Skeel Jr, *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1750 (2002) ("In the United States, institutional shareholders own approximately 50% of the shares of the country's publicly quoted

largest institutional investors to exercise control.[155] Shareholders thus can participate in corporate decisions with low decision-making costs. Consequently, it is external costs, not decision-making costs, that are the main worry for corporate shareholders in the U.K., which makes a higher threshold for charter amendment more appropriate.

3. The Middle Road: France and Germany—French law and German law have taken an approach somewhere in between the approaches of Delaware and the U.K. Under French corporate law, an amendment of the articles of association needs to be approved by a two-thirds majority vote present or represented.[156] A merger transaction also requires a two-thirds majority vote.[157] Shareholders holding or representing one quarter of the voting shares need to be present at an extraordinary general meeting to meet the quorum requirement.[158] If the quorum requirement is not met, a second meeting could be convened where there is no quorum requirement.[159] This enables corporations to move forward without the approval of a supermajority vote by all shareholders.

While current studies have already recognized the importance of an active judicial system in determining the scope of mandatory rules in corporate law,[160] judicial capacity is apparently not the sole factor since it cannot fully explain the differences in corporate law across jurisdictions. One may compare French law with U.K. law and conclude that French law sets a lower threshold for charter amendment—a two-thirds majority vote of shares and no quorum

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companies, with the remainder held directly by individual investors. In the U.K., in contrast, the equivalent figure is more than 70%.").

155 *Id.* at 1751 ("In Britain, it is common for a company's twenty-five largest institutional investors to own a majority of the shares. In the U.S. the same number of institutions will typically only own about one-third of the equity in a corporation.").

156 CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] art. L. 225-96 (Fr.) (*Translated to English*), [https://perma.cc/V6P4-6CS9].

157 *Id.* arts. L. 236-2 and L. 225-96. This is also the minimum requirement for public companies in Europe. Council Directive 78/855, art. 7, 1978 O.J. (L 295) 38.

158 CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE], *supra* note 156, art. L225-98 (An ordinary general meeting can make decisions "only if the shareholders present or represented hold at least one fifth of the voting shares" when it is first convened.).

159 *Id.* art. L. 225-96.

160 *See generally* Coffee, Jr., *supra* note 32, at 1293 (describing the courts' lack of involvement in repurchasing rules and corporate liability).

requirement, whereas in the U.K., a three-fourths majority is necessary. This does not suggest, however, that the French court is more capable of detecting opportunist actions by corporate insiders.

This Article provides an explanation more aligned with the reality: the decision-making costs in France may be higher compared to the U.K. In the U.K., corporations are held mainly by institutional investors who have a strong presence in corporate governance.[161] By contrast, corporations in France usually have concentrated ownership, while institutional investors traditionally play only a small role compared to those in the U.K. and the state of Delaware.[162] For a long time, households in France owned a significant proportion of shares of listed corporations.[163] Thus, a three-fourths supermajority vote may incur relatively high decision-making costs in France. Additionally, since many French companies have a controlling shareholder holding a majority of shares, a simple majority rule is likely to incur high external costs. Examining both external and decision-making costs enables a clearer understanding of rules governing corporate charter amendments in France.

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161 CHEFFINS, *supra* note 111, at 64 (1997); Black & Coffee, Jr., *supra* note 153, at 2002 ("U.K. institutions hold about two-thirds of all publicly traded British stocks, while U.S. institutions only hold around half of U.S. publicly traded stock.").

162 *See* Org. for Econ. Co-operation and Dev. [OECD], *Corporate Governance: A Survey of OECD Countries*, at 33 (2004), https://www.oecd.org/corporate/ca/corporategovernanceprinciples/21755678.pdf. [https://perma.cc/5UYT-R9HC]; Org. for Econ. Co-operation and Dev. [OECD], *OECD Economic Surveys: France*, at 118 (1997), https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-france-1997_eco_surveys-fra-1997-en [https://perma.cc/GLJ6-A4GJ]. *See also* Antoin Murphy, *Corporate Ownership in France: The Importance of History*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 185, 188 (2005) (listing concentration of ownership and extensive family ownership as two of the most salient features of France's current corporate ownership structure). Statistics show that above 24% of the largest 416 French firms have a controlling shareholder. James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT'L L.J. 31, 42 (1998). The average level of shareholder attendance is only about 30% of the corporate capital. Yvew Guyon, *France*, *in* SHAREHOLDER VOTING RIGHTS AND PRACTICES IN EUROPE AND THE UNITED STATES 95, 102 (Baums Theodor & Eddy Wymeersch eds., 1999). Statistics show that in the largest 155 French companies, only 48 of them have institutional investors. Julian Franks & Colin Mayer, *Corporate Ownership and Control in the U.K., Germany, and France*, 9 J. APPLIED CORP. FIN. 30, 36 (1997). Some other studies suggest that the proportion of shares held by individuals is lower. Gérard Charreaux & Peter Wirtz, *Corporate Governance in France*, 1-11 (2007). However, this is likely because many individuals hold equity interests by owning non-financial corporations.

163 *See* Fanto, *supra* note 162, at 43.

Consider for example two hypothetical corporations, one in France and one in the U.K. The French corporation has a controlling shareholder holding 30% of the shares and several institutional investors holding 10% of the shares in total, while the rest are held by individual shareholders who do not have incentives to participate in corporate decisions. Setting the threshold for charter amendment at three-fourths majority may allow the institutional investors in the French corporation to effectively block the amendment. However, since these shareholders hold only 10% of the shares of the corporation, their decision does not necessarily reflect the interests of all the shareholders.[164] They may hold out the decision for their personal benefits. Therefore, lowering the threshold to two-thirds may significantly reduce decision-making costs. In the U.K. corporation, by contrast, institutional investors who have both the incentives and the expertise for participating in a charter amendment decision hold a majority of the stocks, while individual shareholders hold only about 10%. A three-fourths majority is not likely to give rise to high decision-making costs since shareholders attending a meeting are likely to hold a high proportion of the shares of the corporation, making it difficult for any particular shareholder to hold out the decision without holding a significant block of shares in the corporation.[165] Thus, a three-fourths majority rule may incur high decision-making costs in France but not in the U.K.

Germany takes a different, but similarly balanced approach. While the articles of association can be amended by a majority vote below the three-fourths level, amendment of important provisions, including, for example, the purpose of the corporation, must have a three-fourths vote.[166] The issuance of a new class of preferred stocks and merger transactions also need a three-fourths majority vote.[167] When a decision of the corporation negatively affects the interests of a class of shares, it needs to be approved by a three-fourths majority

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164 *See generally* Goshen, *supra* note 7.

165 *See* Franks & Mayer, *supra* note 162.

166 *See* Stock Corporation Act (Ger.), *supra* note 117, at 1142, § 179. *See also id.* §§ 182(2), 186(1), 193, 202(2), 222. For relatively trivial matters, a simple majority would suffice. *See, e.g.*, *id.* § 113(1); Ernest C. Steefelt & Bernhard von Falkenhausen, *New German Stock Corporation Law*, 4 CORNELL L. REV. 518, 541 (1967) (explaining that although most resolutions pass by a simple majority, anything above normal importance requires a three-fourths majority).

167 *See* Rock et al., *supra* note 12, at 197.

vote of the shareholders adversely affected.[168] Additionally, German law does not allow shareholders to delegate the power to the board of directors to approve the amendment of corporate charters, except in several limited circumstances, including, for example, "the authority to make amendments that relate solely to the wording of the articles."[169]

The factor of institutional investors may also explain the shareholder voting rules under German law. Amending corporate charters in Germany is still relatively easier than in the U.K., where any amendment needs a three-fourths majority. This can again be explained by the fact that institutional investors, such as banks, trusts, and insurance companies, play a smaller role in Germany than in the U.K.[170] Institutional investors have both the expertise and the incentives to participate in corporate governance. Corporations with many institutional investors thus may incur lower decision-making costs in using a supermajority rule compared with a corporation with many retail investors. The dominant corporate financial structure in Germany can also explain why German law did not choose a simple majority rule. In Germany, most listed corporations are held by a controlling shareholder.[171] A simple majority rule would incur high external costs since the majority shareholder would dominate the amendment of the corporate charter.[172]

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[168] *See* Stock Corporation Act (Ger.), *supra* note 117, at 1142, § 179.

[169] *Id.* §§ 119, 179(1). Shareholders may also "authorize [sic] the management board [. . .] to increase the share capital up to a specified par value (authorised [sic] capital) by issuing new shares against contributions," or to cancel shares by means of mandatory redemption. *Id.* §§ 202(1), 237(6). Moreover, shareholders can act without actions from the board. Rock et al., *supra* note 12 at 186.

[170] *Id*. *See also* Franks & Mayer *supra* note 162, at 33-37 (providing comparative statistics of the proportions of shares owned by different groups within France, Germany, and the U.K.); Thomas Kirchmaier & Jeremy Grant, *Corporate Ownership Structure and Performance in Europe*, 2 EUR. MGMT. REV. 231, 237 (2005) (comparing the ownership of institutional shareholders to those of other owners in France, Germany, Italy, Spain and the U.K.).

[171] Theodor Baums, *Germany*, *in* SHAREHOLDER VOTING RIGHTS AND PRACTICES IN EUROPE AND THE UNITED STATES 113 (Theodor Baums & Eddy Wymeersch eds., 1999); Gur Aminadav & Elias Papaioannou, *Corporate Control Around the World*, Working Paper 23010 http://www.nber.org/papers/w23010, at 49 (2016).

[172] The above analysis also explains the difference between German law and French law. Although corporations in both Germany and France have concentrated ownership, studies suggest that banks play a relatively larger role in Germany since they hold a larger proportion of shares in corporations. Franks & Mayer, *supra* note

2.2. Mandatory Rules in Corporate Law

The above theory can also explain mandatory rules in corporate law, since mandatory rules can also be viewed as charter amendment rules that bar shareholders from amending certain provisions in the corporate charters. Mandatory rules in corporate law have long been an interesting subject for corporate law scholars.[173] In the academic literature, a corporation is often referred to as a "nexus of contracts."[174] The contractarian view, most famously supported by Frank Easterbrook and Daniel Fischel, posits that corporate law mainly contains enabling rules as default contractual terms, which reduce the transaction costs between different parties in a corporation, including shareholders and managers.[175] Easterbrook and Fischel argue that corporate law is what the parties would have agreed upon had the transaction costs been lower. Since the transaction costs of enacting the corporate contract are often too high, corporate law provides the fiduciary duty enforced by courts, which allows courts to "fill the gap" in the corporate contract.[176] If corporations are like contracts, parties to a corporation should thus be allowed to write their own contract to further their interest. It thus remains an interesting question what justifies mandatory rules in corporate law.

Jeffrey Gordon has famously proposed an opportunistic amendment hypothesis, which is the dominant theory that explains mandatory rules.[177] Corporations may opportunistically amend the charter after shareholders invest in the corporation.[178] The decision

162, at 32-35. This is consistent with the fact that German law has provided a higher threshold for charter amendment compared to French law.

173 *See* Gordon, *supra* note 9; Romano, *supra* note 18; Black, *supra* note 18; Bebchuk, *supra* note 18; Eisenberg, *supra* note 18.

174 *See* Michael C. Jensen & William H. Meckling, *Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976) (describing organizations as legal fictions that "serve as a nexus for a set of contracting relationships").

175 *See* Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 33, at 737; Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 33, at 427.

176 *See* Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 33, at 427.

177 *See* Gordon, *supra* note 9, at 1591. Romano, *supra* note 18 Black, *supra* note 18.

178 One example is the charter amendment rules themselves. While charter amendment rules in corporate laws across the globe usually provide that

to amend the corporate charter may not reflect the true consent of shareholders.[179] Such midstream changes would allow corporate insiders to enhance their power and even to entrench themselves.[180] Thus, even scholars who fully embrace the contractarian view should be suspicious when a corporation amends its charter because true consent is difficult to obtain given the holdout problem.[181]

Scholars have pointed out that the opportunistic amendment hypothesis has serious drawbacks. For example, Romano argues that corporations are allowed to adopt takeover defenses which may harm the interests of shareholders and benefit corporate insiders.[182] The opportunistic amendment hypothesis does not fully explain this

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shareholders can amend the corporate charters with a supermajority or a majority vote of shares, these charter amendment rules themselves are not subject to the same rule. For example, in the state of Delaware, the mandatory charter amendment rules include the following: (1) while shareholders are generally free to delegate the power to amend the bylaws to the board of directors, they cannot delegate the power to amend the certificate of incorporation to the board; (2) shareholders must vote on certain mergers. DEL. CODE ANN. tit. 8, §§ 109, 242, 251(c). Corporate laws in other states of the United States are similar to the state of Delaware in granting strong power to the board of directors. Bebchuk, *supra* note 29, at 844. These rules can be termed "non-delegation" rules in corporate law, similar to the non-delegation doctrine in administrative law. Moreover, listed corporations in the United States also cannot amend their charters to establish a dual class share structure, which allow some shareholders to decide the amendment of the corporate charter. Voting Rights Listing Standards, 53 Fed. Reg. 26,376 (July 12, 1988). *See also* Rock et al., *supra* note 12, at 192. These rules bar shareholders from delegating the amending power to the board of directors or a class of shareholders who are usually insiders of the corporation. Similarly, the 2006 Companies Act in the U.K. mandates that any amendment to the articles of association needs a supermajority vote of shares, thus preventing shareholders from delegating the power of amending the articles to shareholders holding only a majority of shares. Additionally, German law also does not allow shareholders to delegate the power to the board of directors to approve the amendment of corporate charters, except in several limited circumstances, for example in making "amendments that relate solely to the wording of the articles." Stock Corporation Act (Ger.), *supra* note 117, §§ 119, 179(1). Shareholders may also "authorise [sic] the management board [. . .] to increase the share capital up to a specified par value (authorised [sic] capital) by issuing new shares against contributions," or to cancel shares by means of mandatory redemption. *Id.* §§ 202(1), 237(6).

179 Gottlieb v. Heyden Chemical Corp., 90 A.2d 660, 665 (Del. 1952) (noting where a board of directors of the defendant corporation adopted a restricted stock plan to come from authorized but not yet issued and reacquired shares. Plaintiff challenged because of her pre-emptive rights which was dismissed by the chancery court. The Supreme Court of Delaware re-manded for trial). Branson, *supra* note 40, at 392. Rock et al., *supra* note 12, at 24.

180 *See* Gordon, *supra* note 9, at 1573.

181 *See* Bebchuk, *supra* note 25, at 1820-1860.

182 *See* Romano, *supra* note 18, at 1606.

phenomenon. Moreover, the opportunistic amendment problem could, in theory, be addressed by raising the threshold for amendment to a supermajority rule or a unanimity rule.[183] If, as scholars argue, that opportunistic amendment is the only problem, shareholders can simply agree to certain "entrenched provisions" in the initial charter that certain rules can never be amended, thus barring all midstream changes from occurring.[184] In fact, the Companies Act of the U.K. provides a special type of provision in the articles of association called "entrenched provisions."[185] These provisions may be made either upon formation of the corporation or "by an amendment of the company's articles agreed to by all the members of the company," (i.e. by unanimous consent of all shareholders). Specifically, shareholders can agree in the initial corporate charter that the charter amendment rule cannot be amended in the midstream without unanimous consent of shareholders.

The opportunistic amendment hypothesis cannot explain why mandatory rules are still necessary under these circumstances. One explanation is that mandatory rules may incur lower decision-making costs compared to entrenched provisions because there is still some chance that mandatory rules would be amended later by statute or modified by a court through an altered interpretation of such rules. The decision-making costs of mandatory rules may still be higher than most rules of supermajority vote, depending on how frequently the state amends its corporate statutes.

The constitutional economic theory offered in this Article can better explain the mandatory nature of charter amendment rules by suggesting that shareholders should choose different charter amendment rules for different issues to balance external costs and decision-making costs. For provisions in a corporate charter concerning the fundamental interests of shareholders, state legislatures may treat these provisions as mandatory because

183 Klaus J. Hopt, *Directors' Duties and Shareholders' Rights in the European Union: Mandatory and/or Default Rules*? 9, 13-32 (Eur. Corp. Governance Inst. [ECGI] 1, Law Working Paper No. 312/2016, 2016), https://ssrn.com/abstract=2749237 [https://perma.cc/5HCL-F3WF].

184 Under the 2006 Companies Act of the U.K., shareholders can agree to a set of "entrenched provisions" which cannot be amended unless by unanimous consent. Companies Act 2006, c. 46, *supra* note 1, § 22 (Eng.).

185 *Id.*

reducing external costs is more important.[186] Mandatory rules incur lower external costs compared to a majority vote or a supermajority vote by shareholders, since corporate insiders cannot opportunistically amend the charter. They are thus similar to a unanimous vote by shareholders from an external-cost standpoint.

The above analysis also explains why mandatory rules in corporate law vary over time and across jurisdictions, which has not been satisfactorily explained by existing theories. Eisenberg argues that certain constitutive rules, including structural rules, distributive rules, and fiduciary rules, should be mandatory.[187] Structural rules "govern the allocation of decisionmaking power among various corporate organs and agents and the conditions for the exercise of decisionmaking power," while distributive rules refer to rules that "govern the distribution of assets (including earnings) to shareholders."[188] These rules are important to prevent managers from entrenching themselves at the expense of shareholders.[189] Similarly, Gordon distinguishes four types of mandatory rules: procedural, power allocating, economic transformative, and fiduciary standards setting.[190] However, these mandatory rules have all been qualified to some extent.[191] One important reason for that qualification is that strict mandatory rules prevent corporations from adopting innovative provisions necessary to cope with emerging circumstances. Relaxing some of the constitutive rights and structural rules may reduce decision-making costs. Additionally, many alternative mechanisms, including shareholder voting and market reputation, may help curb the opportunistic amendment problem. The development of these institutional

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186 It should be pointed out that current discussions in the academic literature often use the term mandatory rules to refer to *ex ante* rules prescribed by legislatures but not *ex post* decisions made by courts. Gordon, *supra* note 9, at 1553 n.16. Both of them are referred to as mandatory rules in corporate law in this Article. They are both interventions by a third party (state) in corporate charter amendments.

187 *See* Eisenberg, *supra* note 18, at 1462.

188 *Id.*

189 Eisenberg refers to this type of divergence of interests between managers and shareholders as "positional conflicts." *Id.* at 1480.

190 *See* Gordon, *supra* note 9, at 1591.

191 As Roberta Romano points out, many other amendments to corporate charters that are not mandatory may also affect shareholders' interests. Romano, *supra* note 18, at 1606. Although Eisenberg has considered the rationale behind the choice between these approaches, he has not systematically explored the factors behind the costs of various approaches to charter amendment. *See, e.g.* Eisenberg, *supra* note 18, at 1471.

constraints may allow legislators to replace mandatory rules with more flexible rules without the risk of increasing external costs.

Where courts are capable of detecting wrongdoing and curbing opportunistic amendment ex post, ex ante mandatory rules can be lifted to some extent. For example, courts in many states in the United States once prohibited corporations from amending their corporate charters and issuing a senior class of securities because doing so violated the "vested property interests" of shareholders.[192] The issuance of a new class of securities apparently affects the interests of the existing shareholders and changes the "distributive rules" of a corporation. Courts thus repeatedly enjoined against such changes based on the "vested rights" theory.[193] However, the courts' stance had gradually shifted in the early 20th century and eventually permitted the issuance of new securities.[194]

Another example is the rule of fiduciary duty under corporate law. While it is regarded as a constitutive rule, Delaware allows corporations to exempt directors from liability for breach of their duty of care.[195] The theoretical framework of external and decision-making costs together explains why not all constitutive rules are mandatory in all jurisdictions and why ex ante mandatory rules may change over time.[196]

Lele and Siems compiled a "shareholder protection index," and attempted to compare the strength of shareholder protection across countries by aggregating the scores for each country.[197] They found that the law of the United States does not offer very strong protection for shareholders compared to many European countries.[198] This Article postulates that the index compiled by Lele and Siems overlooks the possibility that in countries where judicial review and alternative mechanisms offer strong constraints on corporate conduct and protection for outside shareholders, relaxing ex ante mandatory rules may reduce decision-making costs. Thus, having relatively light regulations on corporate internal governance mechanisms in the corporate law does not suggest that the corporate

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192 *See* Coffee, Jr., *supra* note 34, at 1640.

193 *See* Coffee, Jr., *supra* note 34, at 1641.

194 *Id.*

195 DEL. CODE ANN. tit. 8, § 102(b)7; Romano, *supra* note 18, at 1601.

196 For a discussion of the historical development of the vested property interest doctrine, see Branson, *supra* note 40; Latty, *supra* note 103, at 1-51.

197 *See* Lele & Siems, *supra* note 34, at 43.

198 *Id.*

law is weak in protecting shareholders in a specific state. In fact, most of these variables Lele and Siems choose are about the rules governing internal governance mechanisms, including for example, rules governing shareholder meeting, composition of the board, agenda setting power, shareholders' rights to information, and mandatory rules in corporate law.[199] They have not considered the important role played by courts and the stock exchanges in regulating corporate decisions.

It should be noted that the above discussion of mandatory rules only considers the shareholder-manager relationship, rather than the broader panoply of relationships between shareholders and other stakeholders such as creditors, consumers and laborers. Corporate law contains provisions that protect the interests of creditors, which are made mandatory to prevent shareholders from amending them to obtain more benefits at the expense of creditors. An example would be the unique structure of the board of directors in Germany, which offers strong protection to laborers.[200] The analysis for relationships of that nature would be different since such relationships are about the conflicts of interests between shareholders and other stakeholders that shareholder voting cannot resolve.

2.3. The Appraisal Remedy

Apart from mandatory rules, the appraisal remedy also governs the amendment of some charter provisions. In the United States, every state grants the appraisal remedy to minority shareholders in the case of a merger that also triggers an amendment to a corporate charter. Some states grant appraisal rights when a corporation amends its charter.[201] Many scholars have launched criticisms against appraisal rights, questioning whether those rights can protect minority shareholders. One of the most important criticisms

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[199] *Id.*

[200] *See* Luca Enriques et al., *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 101 (Oxford University Press 2nd ed. 2009).

[201] *See* Mahoney & Weinstein, *supra* note 24 at 239. In Delaware, corporations may provide in their charter that an amendment to the corporate charter would trigger the appraisal rights. DEL. CODE ANN. tit. 8, § 262(c).

of the appraisal remedy is that courts often impose strict procedural constraints on dissenting shareholders who seek the appraisal remedy.[202] In addition, appraisal rights can be "a frightful nuisance, drain, and burden" on listed corporations.[203] Corporations cannot know in advance how many shareholders would dissent and, hence, cannot easily calculate the amount of cash they need to prepare in advance. These problems may prevent efficient merger transactions from occurring.[204] In subsequent studies, scholars have generally agreed with Manning's critique on the inability of appraisal rights to protect minority shareholders.[205]

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202 *See* Manning, *supra* note 24, at 227, 230-33. Apart from the procedural costs, scholars have provided many other criticisms. Some scholars argue that shareholders would not vote against a value-decreasing amendment because of the rational ignorance problem. Bebchuk, *supra* note 25 at 1854 ("[I]t is far from clear that a substantial fraction of the shareholders will file for appraisal. Because of the rational ignorance problem, the fraction of shareholders voting against a value-decreasing amendment might often be quite small or even nonexistent."). Another problem is that the costs of appraisal are borne by other shareholders, whose interests do not concern managers. Bebchuk, *supra* note 25, at 1854 ("The cost of their use of their rights, however, will not be borne by the managers but rather by the other shareholders."); Black, *supra* note 18, at 583. Perhaps the earliest and the most famous critique was offered by Bayless Manning in 1962. Manning questions the underlying rationales of the triggering conditions for appraisal right. It has been unclear, Manning argues, that shareholders should be able to "jump clear of the corporate enterprise if they do not like its course." Apparently, many events may threaten the interests of shareholders in a corporation, including for example, the corporation filing involuntary dissolution, change in business scope, a massive dividend distribution, "Mass resignation by the management," "introduction of a new product by a competitor," and even "a Presidential heart attack." However, many states only allow shareholders the appraisal rights in a corporate merger, while some grants the appraisal remedy when a corporation amends its charter. Manning, *supra* note 24, at 237-239, 241-244. For earlier discussion, see Brown, *supra* note 25, at 845; Note, *supra* note 25, at 340-343.

203 *See* Manning, *supra* note 24, at 234.

204 *Id.* at 235.

205 *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 70 (1976) (arguing that the exercise of appraisal rights is "highly technical, drawn-out, and expensive"); Richard M. Buxbaum, *The Dissenter's Appraisal Remedy*, 23 UCLA L. REV. 1229, 1253-54 (1976) (analyzing the vices of appraisal procedures in California's new corporation law); Mahoney & Weinstein, *supra* note 24, at 243-45 (providing empirical analysis on how appraisals may reduce shareholder gains on average in transactions involving "self-interested managers"); George S. Geis, *Internal Poison Pills*, 84 N.Y.U. L. REV. 1169 (2009) (discussing the idea of an "internal poison pill" as an alternative mechanism to govern the tension between minority and majority shareholders); Thompson, *supra* note 24, at 11-12 (discussing the new transactional settings for appraisal processes, and how they require amendments to the appraisal provisions).

Constitutional economic theory offers justification for the procedural costs imposed on shareholders and on corporations. The appraisal remedy *should* be made costly both for the corporation and for shareholders. [206] On the one hand, it is intended to curb opportunistic actions by the majority shareholders or insiders and, thus, would inevitably impose costs on the corporations.[207] On the other hand, the design of appraisal rights should also generate significant costs for minority shareholders. If minority shareholders are offered an appraisal remedy that is not costly at all, they would be incentivized to exercise that right opportunistically, which would increase the decision-making costs of a merger or a corporate charter amendment.[208]

For example, one of the crucial questions in an appraisal regime is how the fair value of the stock should be calculated. Should a court simply award the shareholder the market price of their stock? Or should shareholders be entitled to certain "inframarginal value" or, in a merger situation, a proportion of the premium generated by

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206 *See* Vorenberg, supra note 27, at 1216-17 ("[B]alancing the relative dangers of oppression by the majority and harassment by the minority and what weight is accorded the importance of giving considerable leeway for change and growth."); Note, supra note 25, at 340:

> Financial burdens incident to appraisal proceedings, however, can thwart the compensatory adjustment intended by the statutes. Unless a shareholder can shift these burdens, appraisal may be a barren right. On the other hand, if his threat of costly proceedings can extort exorbitant settlement, appraisal rights so abused may block or heavily tax desirable corporate change.

207 *See* Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 8 AM. B. FOUND. RES. J. 875, 901-02 (1983).

208 *See* Norman D. Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes*, 45 HARV. L. REV. 233, 233-234 (1931):

> The problem of the dissenting stockholder and his remedies under modern appraisal statutes has been one of conflict between strong and divergent interests. On the one hand is the need of flexibility, ease, and dispatch when change in structure or financial reorganization through one of several means is necessary . . .Contrariwise stands the interest of the minority who have honest convictions in the matter.

See Henry W. Ballantine & Graham Lee Jr. Sterling, *Upsetting Mergers and Consolidations: Alternative Remedies of Dissenting Shareholders in California*, 27 CALIF. L. REV. 644, 651 (1939) (discussing "the desirability of making appraisal of the shares exclusive of irresponsible attacks to set aside a consolidation or merger is at least a fairly debatable measure [. . .]" and how it is necessary to device "forms of remedies which will not unduly hamper and threaten the transaction of legitimate business.").

the offer in the merger?[209] Simply awarding shareholders the market price would be meaningless; shareholders could simply sell their shares without resorting to litigation. However, giving shareholders a premium would encourage them to opportunistically hold up the decision to amend the corporate charter in order to obtain that premium.

Viewed from the perspective of external and decision-making costs, the strict procedural constraints on the exercise of appraisal rights and the uncertainty in the calculation of the fair value of stocks can achieve a balance between external and decision-making costs.[210] In fact, the appraisal remedy is almost always entangled with the question of misconduct by controlling shareholders and determined by courts on a case-by-case basis. When courts detect wrongful conduct committed by a majority shareholder, they tend to provide a favorable appraisal remedy to minority shareholders.[211]

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209 *See* Wertheimer, *supra* note 26, at 680, fn. 339 (arguing that "wrongdoing or breach of fiduciary duty significantly impacts the outcome of appraisal proceedings."); *Cavalier Oil Corp.*, 564 A.2d at 1137; *In re Radiology Assocs.*, 611 A.2d at 485 (Plaintiff stockholder brought a claim against defendants challenging the fairness of his shares' price set forth by the corporation, when the shares were eliminated because of a merger. The court was faced with the issue of how to determine the fair price of the shares when granting the appraisal remedy; the Court held that in the particular case the preferred valuation method was the discounted cash flow analysis, taking into account that the other available methods did not adequately reflect the shares' market value). *Neal*, 1990 WL 109243, at *1. (Plaintiffs, minority stockholders of Alabama By-Products Corporation, made a claim seeking appraisal of their shares as the result of a merger based on which Alabama By-Products Corporation was absorbed into the Drummond Company, Inc. The minority shareholders of Alabama By-Products Corporation were cashed out. As dissenting minority shareholders, petitioners considered the price of their shares inadequate, and filed a claim for unfair dealing, along with an appraisal action.). *See also* Koh, *supra* note 26, at 433-34. (describing three possible sub-concepts of fair value: pro-rata going concern value, but-for value, and fair synergy distribution value).

210 Similar arguments have been made before but have not drawn sufficient attention. *See* Irving J. Levy, *Rights of Dissenting Shareholders to Appraisal and Payment*, 15 CORNELL L. Q. 420, 442-443 (1929-1930) ("[A]rbitrarily to tax such costs against the corporation might encourage objecting stockholders to use the remedy for blackmailing the corporation with unreasonable demands. To levy them against the stockholders would have a similar opposite effect.").

211 *See* Kanda & Levmore, *supra* note 26, at 433. Wertheimer, *supra* note 26, at 680, fn. 339 (arguing that "wrongdoing or breach of fiduciary duty significantly impacts the outcome of appraisal proceedings."); *Cavalier Oil Corp.*, 564 A.2d at 1137; *In re* Radiology Assocs., 611 A.2d at 485; *Neal*, 1990 WL 109243, at *1. *See generally* Koh, *supra* note 26.

The above analysis casts doubt on the proposal that the current procedural requirements for appraisal rights should be modified to make the remedy less onerous for minority shareholders. [212] Relaxing the procedural requirements and burdens on minority shareholders may render it too easy for shareholders to claim appraisal and would, thus, significantly raise the decision-making costs for corporations.[213]

The constitutional economic theory also explains why the appraisal remedy has been, so far, mainly a unique feature of the law in the United States, while in the U.K., France and Germany, dissenting shareholders are offered a way out only in exceptional circumstances. [214] One of the dominant factors in considering whether to grant appraisal rights to dissenting shareholders is the capacity of the court.[215] The appraisal remedy will be more effective if courts can accurately detect wrongdoings by controlling shareholders and determine the fair value of stocks accurately without significant systemic errors.[216] Whether it is a desirable rule in a specific state also depends on how effective a supermajority vote would be. The presence of the appraisal remedy in the United States again suggests that the legal system in the United States is more sophisticated than others. For example, France offers minority shareholders a way out if the controlling shareholders hold more

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[212] *See, e.g.,* Wertheimer, *supra* note 26, at 708 ("A third area where appraisal statutes could be improved is with respect to the procedures incident to the remedy. In many statutes, the procedural requirements imposed on a dissenting shareholder remain excessively onerous.").

[213] The development of the appraisal rights in Canada provides a good illustration of this point. When Canada first introduced the regime of the appraisal remedy, courts were generally sympathetic with dissenting shareholders and set the fair price above the market price. This attitude changed later, however, since courts realize it was important to balance the interests of dissenting shareholders and those of the corporation. Brian R. Cheffins & J. Dine, *Shareholder Remedies: Lessons from Canada*, 13 COMPANY LAWYER 89, 92 (1992).

[214] In Belgium and France, the statutes do not provide appraisal rights for dissenting shareholders in listed corporations. *See* Sofie Cools, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 727 (2005); Decree No. 88-603 of May 7, 1988, J.O., May 8, 1988, p. 6606, arts. 5-5-1 to 5-5-6 (Fr.).

[215] Many scholars question the ability of courts to measure the value of the charter amendment accurately. *See, e.g.*, Bebchuk, *supra* note 25, at 1855.

[216] *See* Wertheimer, *supra* note 26, at 678 ("In cases where the dissenting shareholders achieve a favorable result, there almost invariably is evidence that the acquiring party acted inequitably or engaged in overreaching.").

than 95% of the shares in the corporation.[217] However, under French law, a market regulator, the Financial Markets Authority, not the courts, is in charge of the enforcement of the appraisal remedy.[218] The additional challenge posed by this difference is that the appraisal remedy may be difficult to enforce for a jurisdiction where courts are not accustomed to dealing with the evaluations of a corporation.

3. IMPLICATIONS

The above framework of external and decision-making costs has important theoretical implications on two lines of academic discussions: the debate of whether to empower shareholders in the United States and the role of law and contract in corporate governance. This Section will address these implications.

3.1. Choosing Mandatory Rules in Corporate Law

The above analysis provides a theoretical framework for analyzing the social costs and benefits of making certain rules in corporate law mandatory, which may benefit developing countries where policymakers have yet to determine whether to employ mandatory rules in corporate law to regulate charter amendment. The analysis suggests that in evaluating the costs of mandatory rules, we must also consider mandatory rules enacted by alternative institutions such as stock exchanges. Stock exchanges play a significant role in enacting mandatory rules that apply to corporations listed at a certain exchange. For example, in the United States, the New York Stock Exchange ("NYSE") has long prohibited deviation from the "one-share-one-vote" principle, although some stock exchanges proposed to change this rule in recent years.[219] In

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[217] *See* CHRISTOPHER JOSEPH MESNOOH, LAW AND BUSINESS IN FRANCE: A GUIDE TO FRENCH COMMERCIAL AND CORPORATE LAW 139 (1994).

[218] *See* Rock et al., *supra* note 12, at 191.

[219] *See* Annie Massa, *Will Wall Street Buy Into the Slow Stocks Movement?*, BLOOMBERG NEWS, (Apr. 13, 2018), https://www.bloomberg.com/news/articles/2018-04-13/will-wall-street-buy-

many other states, this principle is stipulated in corporate law. Corporate law in Germany generally follows the "one-share-one-vote" principle and prohibits any deviation from this principle, including for example, time-phased voting arrangements and voting caps.[220] This Article suggests that there is an important difference between stipulating the "one-share-one-vote" principle in the listing rules of stock exchanges and stipulating that principle in national statutes or regulations. Using listing rules of stock exchanges to regulate the opportunistic amendment problem can significantly reduce decision-making costs since such regulations can be amended relatively quickly to adapt to changing circumstances. If the "one-share-one-vote" principle is made mandatory in corporate law, the decision-making costs would be much higher since amending the corporate statutes incurs much higher legislative costs.

The social costs of mandatory rules in a state also depend on its legal system. In a state with a federal legal system, the decision-making costs of making "one-share-one-vote" mandatory in some states are relatively lower since a corporation can pick the state where it wants to incorporate in. States generally amend their corporate statutes frequently. In a unitary system, by contrast, preventing corporations from adopting schemes that grant more voting rights to some shareholders may significantly affect the ability of the corporations to adapt to new circumstances and thus, force the corporation to incur higher decision-making costs.

3.2. The Debate over Increasing Shareholder Power in the United States

The bilateral veto arrangement in the United States has long been a focus of debate. Some scholars argue that corporate law should increase shareholders' power and allow them to initiate charter amendment.[221] For example, Lucian Bebchuk has provided

into-the-slow-stocks-movement [https://perma.cc/6SKY-5VBQ]; John McCrank, *Silicon Valley firm floats listings plan via 'Flash Boys' exchange,* REUTERS (Mar. 19, 2018), https://www.reuters.com/article/us-usa-listing-iexgroup-ltse/silicon-valley-firm-floats-listings-plan-via-flash-boys-exchange-idUSKBN1GV2MG [https://perma.cc/BV9M-6EAK].

220 *See* Enriques et al., *supra* note 200, at 59.

221 *See generally* Bebchuk, *supra* note 29.

a comprehensive discussion of the benefits of increasing the power of shareholders in the United States. He argues that corporate charters need to adapt to new circumstances, while the veto power of the board will prevent efficient adaptation and create a "pro-management distortion."[222] Others point out that granting power to the board of directors benefits shareholders.[223]

This Article sheds new light on the debate over whether shareholders should be allowed to initiate amendment of corporate charters. Current discussions have focused largely on the shareholder-manager conflicts rather than the conflicts of interests among shareholders.[224] Increasing shareholder power to initiate proposals to amend corporate charters may lead to a rise in external costs since charter amendment would become easier. The amendment of a corporate charter initiated by some shareholders may not benefit shareholders as a whole, since different shareholders may have idiosyncratic interests.[225] For example, in a takeover context, a corporation may have certain defensive tactics such as a staggered board that can enhance the bargaining power of the original shareholders of the corporation and allow them to obtain more benefits from the takeover transaction.[226] If corporate law in the United States increases shareholders' power and allows them to initiate changes to the corporate charter, some shareholders may acquire a significant proportion of shares and seek to amend the takeover defenses in the corporate charter, which may benefit the hostile acquirer at the expense of other shareholders.[227] The requirement that any amendment to the corporate charter needs to be initiated by the board of directors establishes an additional barrier for the amendment of corporate charters and thus reduces the external costs.

To be sure, the exact level of external costs that may arise if shareholders can initiate charter amendment is difficult to measure. It is nonetheless important to note that any proposal to change the bilateral veto regime needs to consider the balance between external

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[222] *Id.*

[223] *See, e.g.*, Bainbridge, *supra* note 30.

[224] *See* Goshen, *supra* note 30, at 791.

[225] *See* Bainbridge, *supra* note 30, at 1745 n.54.

[226] *See* Coffee, Jr., *supra* note 32, at 1175; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, *supra* note 32, at 1169.

[227] Recent studies show that a staggered board promotes the value of a corporation. *See* Cremers & Sepe, *supra* note 32, at 80.

and decision-making costs. If corporate laws in the United States are to allow shareholders to initiate charter amendment and also seek to maintain the same level of external costs, these laws must consider raising the threshold for charter amendment from a simple majority vote of shares to a supermajority votes. Doing so, however, may increase decision-making costs.

3.3. The Essential Role of Corporate Law

Another relevant question in the corporate law literature is whether corporate governance is essentially about law or contract.[228] The theory offered in this Article also offers a new account of why law is important in corporate governance. While shareholders of a corporation can create "entrenched provisions" that are similar in function to mandatory rules—thereby resolving the opportunistic amendment problem—these entrenched provisions may incur high decision-making costs. It is because of these high decision-making costs that mandatory rules become necessary. Mandatory rules essentially allow corporations to "amend" the rules without going through the shareholder voting process and to free ride on the efforts of legislatures and courts.[229]

It should be noted, however, that decision-making costs alone also cannot explain why some provisions are mandatory in corporate law. If decision-making costs were the only concern, states should provide default rules and expect corporations to follow them because such rules would allow corporations to then free-ride on the efforts of legislatures and courts when corporations seek to amend these provisions.[230] The problem is that corporate insiders or controlling shareholders may then amend the provisions in the charter in the midstream in ways that harm shareholders' interests since those provisions are merely default rules that can be amended with relative ease. Mandatory rules can only be explained

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[228] Whose members are mainly nominated and appointed by the controlling shareholder. Hansmann, *supra* note 3, at 9.

[229] Some scholars have noticed that a major function of default rules in corporate law is to reduce decision-making costs. This Article suggests that mandatory rules in corporate law can also be explained with the same theory. Listokin, *supra* note 18, at 279-308. *See also* Hansmann, *supra* note 3, at 9.

[230] *See* Listokin, *supra* note 18, at 279-308.

by considering both decision-making costs and external costs (i.e. the needs for adaptation and commitment).

By taking the perspective of comparative law, this Article also suggests that corporate law plays a larger role in corporate governance in some jurisdictions than others, depending on the legal institutions and ownership structures of the corporations in these different jurisdictions. In jurisdictions where legislatures and courts are more capable of making appropriate rules and detecting opportunist actions, law may play a larger role in corporate governance. Where shareholders can write and amend their corporate contracts with lower costs, however, law may be less important in corporate governance. In the United States, judicial review plays a far greater role in governing midstream changes, while in many other developed countries, supermajority vote by shareholders are more important constraints on charter amendment.

4. CONCLUSION

The corporate charter is the constitution of a corporation. How should it be amended? This Article identifies a fundamental tradeoff between the needs for commitment and adaptation, or, in economic terms, external and decision-making costs. Different provisions in a corporate charter should be subject to different amendment rules. This theory can explain why the charter amendment rules vary significantly between the state of Delaware, the U.K., France, and Germany. This Article has identified several important factors that may affect external and decision-making costs, including judicial capacity, the ownership structure of corporations, and the frequency of and procedural constraints imposed on the amendment of the corporate statutes. Different states may choose different charter amendment rules given their respective institutional constraints.

Within a given state, different charter amendment rules should be chosen to govern the amendment of different rules. Shareholders should delegate the power to the board to amend trivial provisions. For more important issues, shareholders should use a majority vote or a supermajority vote. For provisions that involve the fundamental interests of shareholders, the state legislatures and courts should decide that such provisions are mandatory and cannot be amended. This theory can better explain mandatory rules in corporate law than other theories.

The theory offered in this Article also explains the design of the appraisal remedy. It suggests that the appraisal remedy needs to strike a balance between protecting the interests of dissenting shareholders from controlling shareholders or corporate insiders and preventing dissenting shareholders from holding out a decision that benefits shareholders as a whole. As a result, the use of appraisal remedy must be strictly constrained. This theory casts doubts on proposals to alleviate the procedural burden on dissenting shareholders in exercising their appraisal rights.

The theoretical framework proposed in this Article generates three important implications. This framework first suggests that in deciding whether to adopt mandatory rules in corporate law, policymakers should pay attention to alternative mechanisms that might achieve similar goals without incurring high decision-making costs, especially in emerging economies where the legislative and court systems differ significantly from those in developed economies.

Second, this Article sheds new light on the debate over whether to increase shareholders' power and grant them the power to initiate charter amendment in the United States. The bilateral veto arrangement can be viewed as setting up an additional barrier for charter amendment to reduce external costs. Allowing shareholders to initiate charter amendment reduces the decision-making costs but may raise external costs. While a precise estimation of these costs is usually difficult, any proposal to change the charter amendment rules in the United States needs to consider both decision-making costs and external costs together.

Finally, the theoretical framework offered in this Article deepens the understanding of the role of law and contract in corporate governance. While current studies emphasize the function of law in curbing the opportunistic amendment problem, this Article suggests another function of law—reducing decision-making costs. Moreover, the role of the law may be more important in some jurisdictions than others, depending on the relative costs of shareholder voting and mandatory rules.