Contracts, Elites, and Traditions in the Making of Corporate Law

Robert C. Clark

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CONTRACTS, ELITES, AND TRADITIONS IN THE MAKING OF CORPORATE LAW*

*Robert C. Clark***

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** Dean and Royall Professor of Law, Harvard Law School.

The real motive of this Article is quite general: to explore the most basic considerations arguing for and against major sources of rules. But it takes an inductive approach. The first part describes some key aspects of the recent debate about the choice between mandatory and enabling rules in corporate law. Its purpose is to illustrate the troubled dominance of one major model of the creation of norms—the contractual model—in academic thinking. Later parts explore factors slighted by users of this model, and in doing so introduce ideas that reach far beyond the borders of business law.

I. Introduction: The Debate over Opting Out

A. *Opting Out of Fiduciary Duties*

In 1985, the Delaware Supreme Court handed down an opinion, in *Smith v. Van Gorkom,*[1] that interpreted the fiduciary duty of care owed by a board of directors to its corporation and shareholders in a surprisingly strict way. In response to the alarms then set off by segments of the bar and board, the Delaware legislature enacted a statute that clearly allows any Delaware corporation to adopt by charter amendment a provision limiting or eliminating the personal liability of its directors for monetary damages flowing from a breach of their duty of care.[2] To this limited extent, a corporation will be allowed to ask its shareholders to vote to "opt out" of the otherwise applicable judge-made rules of fiduciary duty. Various other states, apparently fearing massive reincorporations to Delaware,[3] enacted the same or similar statutes.[4]

Delaware, it turns out, had jumped ahead of a similar but more modest proposal being considered by the reporters of the American Law Institute's Corporate Governance Project.[5] Inevitably, some observers wanted to go even further than the ALI reporters or the Delaware legislature.[6] Why, it was asked, shouldn't corporations be allowed

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1. 488 A.2d 858 (Del. 1985). The court found that the directors of a corporation were grossly negligent in approving a merger of their company. It held that their duty of care embraced a duty to become fully informed of all material, relevant information reasonably obtainable before making such a major decision, id. at 872, and decided that they had not been so informed. Id. at 878, 884.

2. 65 Del. Laws 289 (1986) (codified principally at Del. Code Ann. tit. 8, § 102(b)(7) (Supp. 1988)).

3. See Richards, Delaware Shareholders May Limit Directors Liability Under New Law, N.Y.L.J., Aug. 11, 1986, at 35, col. 5, 45, col. 1; Gilligan, Incorporations Are Booming in Delaware, Wilmington News-J., Dec. 8, 1986, at B1, col. 1.

4. E.g., 1986 Mass. Acts 644 (emergency law enacted Dec. 24, 1986), amending Mass. Gen. L., ch. 156B, § 13(b) (1979 & Supp. 1989).

5. Principles of Corporate Governance: Analysis and Recommendations 221–22 (Discussion Draft No. 1, 1985). This provision (later reformulated and designated § 7.17) would allow charter amendments to limit due care liability to an amount no greater than the director's fees received by each director from the corporation.

6. For example, at the May 1986 meeting of the American Law Institute, Judge

to adopt charter provisions opting out of any of the initially applicable rules of corporate law? What could possibly have justified the Delaware legislature in stopping with the duty of care? Why, for example, shouldn't it allow corporations, by majority vote of their shareholders, to excuse directors from liability for breach of the much more important fiduciary duty of loyalty in all of its many guises?[7] If shareholders want to preclude themselves beforehand from suing directors when the latter engage in unfair self-dealing transactions with their corporation, why should the law prohibit them from doing so?

In general terms, the rationale behind these insistent questions is the modern contractual theory of the firm. This theory now dominates the thinking of most economists and most economically oriented corporate law scholars who focus at all on the theory of the corporation.

The strong form of the contractual theory[8] has three essential elements. First, the corporation is simply a fictional entity that serves as the center of a complicated nexus of contractual relationships.[9] It is wrong to view it as organizing production in a radically different way

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Easterbrook interpreted Section 5.09 of Tentative Draft Number Five (1986) of the Institute's proposed Principles of Corporate Governance to authorize a corporation's shareholders to vote to amend its articles of organization to exempt its directors and officers from the fiduciary duty of loyalty—an interpretation that apparently came as a surprise even to those who liked it. Branson, Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors, 57 Fordham L. Rev. 375, 378–800 (1988).

7. See, e.g., N. Wolfson, The Modern Corporation: Free Markets v. Regulation 67–68 (1984); Fischel & Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 Cornell L. Rev. 261, 290–92 (1986).

8. The best exponents and defenders of the strong form of the contractual theory are Frank Easterbrook and Daniel Fischel. See, e.g., Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, 271–79, 283–99 (1986) (extended discussion of the role of corporate law and fiduciary duties as ways of filling in the gaps of the affected parties' agreements); Corporate Control Transactions, 91 Yale L.J. 698, 702 (1982) (fiduciary duties are derived from a hypothetical contract, imagined by judges, between investors and managers dickering with each other free of bargaining costs); see also Haddock & Macey, A Coasian Model of Insider Trading, 80 Nw. U.L. Rev. 1449, 1462, 1468 (1986) (advocating enforcement of explicit or implicit contracts between a firm and its insiders); Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9, 39–47 (1984) (advocating that individual companies be able to opt out of application of the insider trading prohibition to transactions in their shares); H. Butler & L. Ribstein, In Defense of Private Ordering in the Corporation 44–45, 102–03 (Sept. 23, 1988) (unpublished manuscript) (managerial liability rules should be considered standard form contractual provisions from which shareholders can opt out).

9. Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 310 (1976); Fama & Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 302 (1983); Jensen, Organization Theory and Methodology, 58 Acct. Rev. 319, 326 (1983). The concept has been taken up in much recent legal literature. See, e.g., Fischel, The Corporate Governance Movement, 35 Vand. L. Rev. 1259, 1261–62 (1982); Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857, 862 (1984); Scott, Corporation Law and

than markets do; it is wrong, for example, to see firms as "hierarchies" in which decisions are made by "fiat" in contrast to the contractual arrangements that characterize markets. And it is wrong to see corporations as being creatures of the state in any important or fundamental sense.[10]

Second, the proper function of corporate law is simply to provide an efficient set of starting or "default" rules[11] to govern the nexus of contracts. Most of these rules concern issues of governance: rights and duties among directors, officers and investors. Their aim is or should be to mimic the rules that most managers and investors would agree to after a full session of costless but informed bargaining. Proper starting rules will save transaction costs, since relatively few parties will find them unsuitable to their preferences.

Third, except when there are bad third-party effects (alias "negative externalities"), managers and investors should be free to change any of the default rules by mutual agreement. Moreover, most rules described traditionally as being within the subject of corporate law, such as the universal rule against unfair self-dealing by officers and directors or the equally widespread rule against the taking of corporate opportunities, do not involve any significant third-party effects; they concern only the welfare of managers and investors. Consequently, private contracts should almost always dominate over legal rules. Operationally, this means that there should be virtually no mandatory role for corporate law.

To sum up the strong form of the contractual theory in a motto: Everything is negotiable.

Practically minded judges and legislators[12] have been known to dismiss these general arguments out of hand. To many who have had

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the American Law Institute Corporate Governance Project, 35 Stan. L. Rev. 927, 930 (1983); Wolfson, A Critique of Corporate Law, 34 U. Miami L. Rev. 959, 962 (1980).

10. Obviously, if a contractualist were to concede the argument that all contracts are "creatures of the state" to the extent that their existence and effect often depends upon the state's willingness to enforce them, he would also have to view corporations as similarly dependent upon government's exercise of power. His point then would be that corporations are no more dependent upon the establishment of a supportive legal system than ordinary contracts are. Note also that many strong contractualists would tend to minimize the importance of legal recognition and enforcement of contracts. A familiar move in law-and-economics writing is to show how market forces promote compliance with particular agreements, and to suggest that the threat of legal sanction may not add much or may even be counterproductive. See, e.g., Fischel & Bradley, supra note 7, at 274–83.

11. For those who have not been exposed to this jargon from the world of computers, "default rules" are the rules that a program follows in "default" of an explicit choice by the user to have some other principle apply. For example, your word processing program may set paper margins of one inch on all sides unless you take the trouble to learn the relevant commands and set the margins otherwise.

12. And lawyers too, when it has not been in the interest of their principal clients to argue otherwise.

experience in the corporate world, it seems obvious that if a corporation adopts a charter amendment opting out of the fiduciary duty of loyalty, the net effects will be clearly bad for investors. Rational, fully informed shareholders not subject to an artificially distorted choice situation would not agree to such a provision. Therefore, we should not allow managements to propose such amendments.

Proponents of strong-form contractualism are not impressed by such objections, and rightly so. One form of rejoinder is to argue in detail that particular major changes in the rules could be much more favorable to shareholders' interests than one might initially think and that, therefore, it is wrong to assume so readily that rational shareholders would not agree to such changes or that their expressed choices have been coerced or "distorted." Fischel and Bradley have argued at length, for example, that abolition of the right to bring derivative actions against managers for breach of their fiduciary duties might well do shareholders more good than harm, given the costs and abuses that such suits generate and the existence of more powerful market-based controls over managerial misbehavior.[13] If their view is accepted, shareholders would be well advised to vote for a charter amendment precluding such suits. Obviously, then, corporate statutes ought to be changed to allow such amendments. Indeed, one might even change the default rule to one that precludes derivative suits unless the corporation has opted into them by charter amendment.

No doubt many corporate law scholars think that the Fischel-and-Bradley arguments against derivative actions can be hosed down by a torrent of counterarguments.[14] The same might be said of other notable deregulatory arguments made by corporate law commentators.[15] But after any such spirited debate, the strong-form contractualists can come back with their ultimate weapon: the (presumed) norm against paternalism. "Look, you may be right about whether there should be derivative rights of action, or we may be right. But resolution of that disagreement only affects what the default rule should be. The most

13. Fischel & Bradley, supra note 7, at 277–83, 286. Note that abolition of derivative suits would go a long way toward effective abolition of the fiduciary duty of loyalty. Id. at 286–87.

14. For example, managerial self-dealing has to become quite significant before it would justify the high costs of the market-based remedy of a hostile takeover bid followed by installation of new management, and might not be policed much at all in the supposed market for managers. But much lower levels of self-dealing might be remedied or deterred by a derivative suit, which is less costly and involves significant economies of scale for shareholders. For other arguments, see Branson, supra note 6, at 390–94; Carney, Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model, 1988 Wis. L. Rev. 385, 390 (courts may help in settling up with opportunistic managers); Goetz, A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven, 71 Cornell L. Rev. 344, 349–50 (1986).

15. See, e.g., R. Clark, Corporate Law 249–50 (1986), responding to Easterbrook & Fischel's arguments about the corporate opportunity doctrine in their Corporate Control Transactions, supra note 8.

important point, about which all of us should agree, is that ultimately the affected private parties should decide which rule should govern their relationship, because there are no significant externalities from the choice of one rule over another. Whatever the default rule, it should be waivable by the joint agreement of the managers and investors—expressed, for example, in a charter amendment. They should have the final say as to which of us they think is right. We have no business urging lawmakers to adopt mandatory rules."

The instinctive reaction of many practitioners and commentators to this kind of argument is to be disturbed and unconvinced. Surely there must be some mandatory role for corporate law! Surely the arguments for almost absolute freedom to opt out of the rules must be deeply flawed in some way! But specifying exactly why there should be mandatory rules, and identifying theoretically justified and practically useful criteria for distinguishing between waivable and nonwaivable rules, have proven to be extraordinarily difficult. There is a burgeoning literature on this topic.[16] Before commenting upon that literature, it will be useful to describe another, more practically important arena in which the contractual theory of the firm has been critical.

B. *Opting Out of Voting Rights*

Within the last few years, a relatively large number of publicly held corporations have attempted to create capital structures with dual classes of common stock: a class with superior voting rights (to be held mostly by management) and a class with no or limited voting rights (to be held by ordinary investors).[17] A major impetus to form such structures is the fact that they make hostile takeover bids virtually impossible. In order to get effective voting control, a bidder has to buy the superior voting shares held by the incumbent management.

Often, the attempt to create such structures was by means of a charter amendment and subsequent exchange offer. For example, the board of directors of Takoff Corporation would recommend to the shareholders that they vote to approve an amendment to the certificate of incorporation that would authorize the issuance of a new class of common shares, Superior Common. Each share of Superior Common would have 10 votes, as compared to one for each share of the already outstanding common shares, now renamed Ordinary Common. But each share of Superior Common would be entitled to only 90 percent of the amount of dividends going to one share of Ordinary Common, whenever dividends are declared and paid. (On all common stock, the declaration and payment of dividends is discretionary with the board of

16. See articles cited infra note 25.

17. See Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Calif. L. Rev. 3, 4 (1988); Yang, One Share, One Vote: Still One Big Mess, Thanks to the SEC, Bus. Week, July 25, 1988, at 59.

directors, and its discretion is protected by the business judgment rule.) The directors would also announce that, if the amendment were approved, Takoff would make a one-time-only exchange offer to all holders of Ordinary Common: if you turn in your Ordinary Common shares, you will get an equal number of Superior Common shares.

The hope behind such plans was that the amendment would be approved and that management shareholders, but not most public shareholders, would accept the exchange offer. In most cases this is exactly what happened.[18] To understand this result, it must be noted that in many corporations offering such plans the management group already owned a substantial portion of the common shares,[19] thereby making a hostile takeover difficult (though not impossible). Such corporations also tended to have small percentages of their stock held by institutional investors.[20]

An individual public investor faced with Takoff's plan would have trouble evaluating her options. If the dual class common recapitalization plan went through as management hoped, Takoff would be impervious to takeover, and the loss of that possibility could mean a loss in the value of her shareholdings. But how does one put a monetary value on that possibility, given that management was already in a favorable position to resist hostile bids? How does one put a value on the dividend advantage of Ordinary Common (a factor pointing to compliance with management's wishes)? How does one put a value on management's suggestions that it will declare a large special dividend if and only if the plan goes through as it hopes? How does one value managers' claims that they will continue putting their own money and best efforts into the corporation only if the plan goes through? Even if a shareholder was able to put a dollar figure on all these possibilities, she might then face a kind of prisoner's dilemma.[21]

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18. See Gordon, supra note 17, at 27, 56–57.

19. Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807, 821–22 (1987).

20. Id. at 836.

21. For simplicity assume that the issuance of the Superior Common has already been authorized. Shareholder Sue is deciding whether to tender into the exchange offer. She thinks that elimination of the possibility of hostile takeover has a negative value of $50 per share and that the dividend advantage of Ordinary Common is a positive $10 per share.

First she considers what happens if most of the other public shareholders do not tender. (Because of communication costs, she is not sure what they will do, so she will analyze both possibilities and will not consider contacting them so that all could agree to take a coordinated stance. She is sure that management will tender, in order to change its holdings into Superior Common.) Takoff will become takeover-proof no matter what she has done, and her shareholdings (whether held in Ordinary or Superior form) will drop $50 per share in value on account of that factor considered separately. But if she has chosen to stick with Ordinary Common, this loss will be mitigated by the $10 per share dividend advantage. On the assumption that others will not tender, she should not either.

A perception that dual class common recapitalizations were unfair to shareholders led to cries for reform. But the argument that shareholders should be free to contract out of the traditional one share-one vote arrangement if they saw fit to do so was advanced with equal vigor. The commentators took a wide variety of positions.[22] Virtually all who wrote or thought about the issue were forced to take a position on whether and when limits should be imposed on contracting out of corporate law's default rules. More than any other topic, this debate raised uneasiness about the contractual model of the firm to new levels of consciousness.

C. *Opting Out of the Theory?*

Among commentators favoring a mandatory role for corporate law, some seem to suggest a need for stepping outside the contractualist perspective,[23] or even a need to abandon the law and economics framework entirely.[24] Others, taking a more orthodox approach, try to

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Now she considers what happens if most of the other public shareholders do tender their Ordinary Common for Superior Common. Takoff will still be subject to takeover; her shareholdings will not be subjected to a $50 per share drop in value. (She assumes for simplicity that a hostile bidder will offer to buy all kinds of common when it gains control, and will not be able to take unfair advantage of Ordinary Common.) But if she has chosen to stick with Ordinary Common, she will get the $10 dividend advantage and do better than the exchanging public shareholders. Even on the assumption that others do tender, she should not.

If all public shareholders think similarly, then only management will exchange, and hostile bids will be foreclosed. This happens even when it would have been better for the public shareholders if all of them had made a binding agreement with each other to accept the exchange offer in order to preserve the possibility of takeover.

I hasten to concede that some of the simplifications that went into constructing this scenario may be fairly contested. But this admission only highlights the point about the complexity and difficulty of the shareholder's choice.

22. Among the notable contributions are Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock, 54 U. Chi. L. Rev. 119 (1987); Gilson, supra note 19; Gordon, supra note 17; Grossman & Hart, One Share—One Vote and the Market for Corporate Control, 20 J. Fin. Econ. 175 (1988); Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 Geo. Wash. L. Rev. 687 (1986); see also Buxbaum, The Internal Division of Powers in Corporate Governance, 73 Calif. L. Rev. 1671 (1985); Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 Colum. L. Rev. 1145, 1257–58 (1984) (competitive race to bottom between NYSE and NASDQ [which entities may refuse to list companies with nonvoting or limited voting common shares]).

23. E.g., Dallas, Two Models of Corporate Governance: Beyond Berle and Means, 22 U. Mich. J.L. Ref. 19 (1988); Bratton, A Critical Appraisal of the Nexus of Contracts Concept of the Corporate Firm, (forthcoming 74 Cornell L. Rev. (March 1989)); R. Thompson, The Law's Limits on Contracts in a Corporation (Nov. 1988) (unpublished manuscript); cf. Branson, supra note 6, at 398–400 (critique of contractualist view), 400–02 (tentative invocation of "ministate" analogy as alternative).

24. One might also suppose that the opting out controversy would be enlightened by a more organic or relational theory of contracting than the traditional legal one. See I. Macneil, The New Social Contract: An Inquiry into Modern Contractual Relations

support the rationale of nonwaivable corporate law rules from "within" what they themselves describe as a contractual perspective or theory.[25] In general, the paradigm dumpers tend toward discussions that are cloudy (perhaps inevitably so) and more suggestive than persuasive. The orthodox but proregulation contractualists vary in how persuasive they are in convincing the reader that mandatory rules are desirable for certain situations. In my view, some of the writings in this group are extremely persuasive, but all suffer from the lack of a full and accurate description of what they are doing.[26]

My general objective in this paper is to put the contemporary debate about mandatory corporate law rules into a much broader perspective, and to use it as a springboard for developing an elementary

(1980); Macneil, Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus," 75 Nw. U.L. Rev. 1018 (1981). So far this protean approach has not seemed to most writers to be decisive for the current controversy, perhaps in part because both challengers and defenders of the contractual model of the firm can be found who think they have appropriated Professor Macneil's insights. Compare Bratton, supra note 23, at 57–62, with O. Williamson, The Economic Institutions of Capitalism 68–84 (1985) (ch. 3, "The Governance of Contractual Relations").

25. See Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harv. L. Rev. 1820, 1823, 1851–52 (1989) (argues that the contractual view of the corporation does offer substantial reasons for placing limits on opting out of standard rules by charter amendment; develops general criteria for deciding when opt-out freedom should be restricted; and suggests some applications, such as the fiduciary duty-type rules concerning self-dealing and managerial responses to takeover bids); Coffee, No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies, 53 Brooklyn L. Rev. 919, 972 (1988) (arguing that corporations must sustain burden of proving charter amendments opting out of traditional rules of governance are not against public policy, but can meet burden by adopting model provisions supplied by representative group such as ABA or ALI; application to arbitration in lieu of derivative suits); Gilson, supra note 19, at 843 (recommending that midstream charter amendments to establish dual classes of common be disallowed, but that initial public offering of stock with no or limited voting rights be allowed); Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549 (1989) (arguing that even within a contractualist perspective market failures may justify mandatory rules).

Though not a self-professed contractualist, Victor Brudney offers arguments against extreme contractualism that could be interpreted as fitting within a more realistic, transaction-costs-conscious contractualist perspective. Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 Colum. L. Rev. 1403, 1420–27 (1985). The same could be said about my own previously published arguments about the extreme contractualist viewpoint. Clark, Agency Costs versus Fiduciary Duties, *in* Principals and Agents: The Structure of Business 55, 59–71 (J. Pratt & R. Zeckhauser eds. 1985); see also Buxbaum, Corporate Legitimacy, Economic Theory, and Legal Doctrine, 45 Ohio St. L.J. 515 (1984).

26. This claim is elaborated infra at text accompanying notes 44–48, where the ultimately elitist and paternalistic strands in the writings of Bebchuk, Coffee, and Gilson are identified. Incidentally, my argument concerning the presence of these strands in their writing does not imply agreement or disagreement with their recommendations about whether particular kinds of rules should or should not be variable by charter amendment or by other procedures initiated by private parties. Many of the specific observations made by these authors are quite illuminating and persuasive.

theory of different sources of rules. That is, I will classify the major sources of rules in a particular way, and then analyze the most basic factors relevant to determining the optimal mix of sources.

II. Three Sources of Rules

There are many approaches to classifying sources of law. It is most fruitful for purposes of assessing the merits and possible limits of contractualism to focus on the identity of the human beings who establish the rules. This approach gives rise to a threefold classification: contracts, elites, and traditions.

In contractual rule making, the parties subject to a particular set of rules create them for themselves, by their agreement. Contractual rule making is a major instance of autonomy in its literal meaning: the autonomous person is one who gives the law to herself.

In elite rule making, rules are made for the subject parties by other persons who consider themselves to be experts, leaders, or persons in authority. Obvious examples are rules made by legislators, judges, regulatory agencies and professional groups. To the extent that the reform proposals of academic commentators are picked up and applied by elite rule makers with authority,[27] the commentators may be said to participate in elite rule making too.[28] Elite rule making is a major instance of the more general category of heteronomy, the condition of being subject to law given by another. As I use the term in this paper, elite rule making refers only to rule making by contemporary (living) elites.

Traditional rules are rules imposed by prior generations of rule makers (who were usually, but not necessarily, elites). Following traditional rules *because* they are the received or traditional rules puts one in a condition of heteronomy. This is true both of elites who apply and implement traditional rules and of persons who agree to be bound by them in their contractual arrangements. One who follows a tradition escapes from heteronomy only by having a full and independent understanding of the reasons for and against the tradition—an understanding that in fact is very rarely achieved—and then assenting to it even though giving it no deference whatsoever because of the fact that it is a

27. By "authority," I mean a widely acknowledged power to initiate sanctioning processes when the rules are violated.

28. Commentators may participate in the weak sense of merely providing information and ideas that to elite rule makers serve as starting points for their own analysis and decision making, or in the strong sense of furnishing recommendations to which some deference is paid by primary elites because they respect academic opinion in general.

It should be noted that commentators may also participate in contractual rule making, to the extent that their ideas influence the choices made by contracting parties. While this undoubtedly does happen, commentators' influence on elite rule makers seems to be a more salient phenomenon.

tradition. In such a state of liberation, the tradition has virtually ceased to exist for that person.

The legal system offers obvious examples of traditional rule following,[29] such as the strong tendency of common-law judges to follow precedents. That is, they adopt and apply them to particular cases, thus "making" the rules for those cases, and they usually do so without sustained investigation into the reasons for and against the traditional rule and possible alternatives to it. Other normative systems, such as all of the world religions, are marked by an even more intense reliance on traditional rules. Recurring patterns of approval and disapproval in social groups of all sizes make up another kind of normative system. In many such groups the norms that are enforced are emphatically of a customary sort.

My three-part schema of sources of rules may call to mind more familiar distinctions such as that between the private and public sector, or between markets and legal intervention, but it should be clear that this schema is not identical to those limited dualities. The three sources may be found operating in all types of normative systems, not just in legal systems.

In the next three sections, I will identify what I take to be the most fundamental pros and cons of each source of rules.[30] I will then consider what might be said about their proper relationship. For example, should contracts always trump traditional rules? Should we have presumptions favoring one source over the others? Should there be conditions, or meta rules, which determine when a particular source should predominate? What are they? Who should apply them and why?

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29. Instead of speaking about traditional rule making, a phrase that would preserve a verbal parallel to contractual and elite rule making, it is more natural and accurate to speak of traditional rule following. Although traditions do generate rules, and the process is never completed in most ongoing traditions, the predominant contemporary activity with respect to a tradition is, by definition, a following of rules received from past activities of rule makers. Granted, too, that deciding to follow a received rule is itself an act that could be described as "making" the received rule a rule for the present, and even one that must subtly alter the tradition, in however small a degree. See T.S. Eliot, Tradition and Individual Talent, reprinted *in* Selected Essays 1917-1932, at 5 (1932). Even so, the phrase "rule following" better captures the spirit of such decisions. See id. at 4 (stressing that we dwell upon what makes poets original, but in doing so, systematically ignore the great amount they have drawn from their literary tradition).

30. As will be apparent, my normative framework is a consequentialist one. It aspires to assess things in terms of how much they increase or decrease the welfare of individuals. How best to define welfare is a subject about which I have much to say, but in some other article. Here I can only make a few assertions that may shed light on the approach taken in the text. First, welfare is not equivalent to happiness or satisfaction, although happiness may often be a good indicator of what coincides with welfare. Second, welfare is probably best understood in relation to ultimate biological tendencies, such as maintenance or maximization of reproductive fitness. Third, many if not most disagreements about how to define welfare should not affect the basic points about sources of rules that are made in the text.

III. Contractualism Ascendant (But Incomplete)

A. *The Economist's Argument*

From the expressly or implicitly utilitarian viewpoint of most economic reasoning,[31] the argument for contractual rule making is simple but powerful. If *A* and *B* both agree to a rule governing their relationship, both must think they will be better off, or at least not worse off, because of the rule; otherwise they would not have agreed to it. Contractually created rules will tend strongly to be pareto-superior rules: they will make one or both parties better off, and neither party worse off.

Of course, people do make mistakes. They may give themselves rules that do not have the good effects they anticipated, or that do have bad effects they neglected to consider beforehand. As a result, one or even both of the parties to a contract may be worse off because of the adoption of a particular rule. But in comparing different sources of rules, it is always important to focus carefully upon the incentives of the rule makers and the information available to them when they make a rule. When this analysis is done, contractual rule making often seems clearly superior to its chief rivals.

Thus, if we make the plausible assumption that most people are predominantly self-seeking, the parties to a contract would seem to have almost ideal incentives to seek out and adopt the rule that is in their own best interests. Who cares more genuinely about the welfare of *A* and *B* than *A* and *B* themselves?[32] As for possession of relevant information, the parties to a contract are often in a very good position. This is especially so if the knowledge most relevant to choice of a governing rule is "local" rather than technical or general. *A* and *B* are likely to have privileged access to information about their own specific needs and preferences, and superior access to information about the concrete details of the subject matter about which they are contracting.

As economically oriented contractualists are apt to put it, "govern-

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31. Strictly speaking, the possession of a conventional utilitarian viewpoint is an unnecessary limitation. For many economists, perhaps, something "has utility" or is useful for *A* if it promotes *A*'s level of satisfaction or happiness. But one could define the useful as that which promotes *A*'s welfare construed in a nonpsychological or otherwise different sense, such as survival or maximization of reproductive fitness. Either approach would be a consequentialist one, although habit might make us shrink from applying the label of "utilitarian" to the latter. Either approach could support the argument given in the text for contractual rule making, so long as one believes that people tend to do what is useful for themselves when they make agreements. Indeed, it is not even necessary to suppose that people are accurately self-aware of what they are really trying to do, or of what their true welfare is, so long as one supposes that they can apprehend relevant causal relationships and act thereon in a way that in fact tends to promote their welfare.

32. Of course, there are people who appear to have given up hope or to be constitutionally incapable of looking after themselves. But, so the argument goes, these are surely the exceptional cases.

ment," in the person of judges, legislators, or regulators, is only infrequently likely to do better than *A* and *B* on either the incentive or the information dimension. Government regulation is therefore quite unlikely to make *A* and *B*'s contract better for *A* or *B*. Government's role is to produce public goods and deal with negative externalities.[33] Regulation of contractual relationships is therefore justified only when they have adverse effects on third parties.

In sum, the usual economic argument for contractual rule making has two separate parts: (1) absent negative externalities, contracts are almost always pareto-superior moves, and (2) government is unlikely to improve upon them.

This argument immediately becomes more complicated, however, if we factor in a third dimension of assessment. Potential rule makers may differ not only in their incentives and in the information to which they have access, but also in their intrinsic ability to process the information they have and to decide correctly upon the courses of action that are most likely to achieve their goals. Consequently, the economic argument for contractual rule making will stand only if a new empirical supposition is added: elite rule makers such as government officials are not systematically more able to process information well and make good means-end choices or, even if they are superior in these respects, their superiority is not enough to outweigh the incentive and information advantages usually possessed by the parties governed by the rules. Obviously, whether government officials are better or worse than rule subjects at the relevant information processing and decision making may depend on the particular society and the particular subject matter. Even a lackluster government might skim the cream of talent for some areas of its operation.

B. *The Philosopher's Argument*[34]

An approach that at first glance seems radically different from the economic argument is offered by jurisprudential writers who speak of the overriding value of personal autonomy.[35] Contractual rule making

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33. Whether government should also concern itself heavily with redistribution of wealth is, of course, a critical question. Fortunately for our discussion here, it may be enough to note that most contractualists probably accept the propriety in principle of government's engaging in progressive taxation on the one hand and explicit welfare programs on the other, but then go on to argue that redistribution by means of regulating contracts is almost always an inferior and unnecessarily costly way of trying to achieve broader redistributive goals. Whatever the merits of this stance as a universal proposition, it certainly seems plausible in the case of corporate law, where many players on both sides—managers and investors—fall into the wealthiest echelons of society.

34. Obviously, the title here is for ease of exposition; I am only speaking of a small subset of philosophically oriented writers.

35. E.g., C. Fried, Contract as Promise 7 (1981) ("whatever we accomplish and however that accomplishment is judged, morality requires that we respect the person and property of others").

is to be favored because it allows people to exercise their autonomy.

A simple approach to a partial reconciliation of the economic and philosophical arguments for contractual rule making is to interpret them as being different versions of an essentially consequentialist argument which fortunately lead to the same conclusion. One construes autonomy as the value to be maximized. On this view, consequentialism follows easily. Things which promote autonomy, such as contractual rule making, are good; one might even say that they are useful. Things which diminish autonomy, such as elite rule making, are bad or neutral, unless they also promote other recognized values. On this view there is no need to inquire into the functions, or consequences for some supposedly more ultimate goals or values, of valuing autonomy. Nor is there need to speculate about the psychological motives for valuing autonomy as an end in itself. One could elaborate the notion of autonomy in Kantian fashion as being essentially connected to the very concept of what it means to be a rational person. From this it arguably follows that the development and expression of autonomy are good in and of themselves. But one need not elaborate upon the possible consequences for other goals of valuing autonomy.

Nevertheless, this easy solution will not satisfy those who, like myself, find it noncredible that one could seriously view autonomy per se as a major, genuine end in itself. Granted, as a psychological matter, autonomy often feels like an end in itself, just as sensations of pleasure do. But surely we ought to be able to think beyond our own psyches and inquire into the origins and functions of our feelings.

As it happens, many proponents of autonomy make arguments that can be readily reinterpreted as resting on perceptions of more ultimate consequences. For example, it may be argued that repeated and widespread participation in governance, whether by making contracts or participating in local government activities, will make better citizens. One could interpret the underlying insight of this argument to be that practice in and experience of making rules will make people better at it over time, so that it is no objection to widespread participation to note that people may make foolish mistakes at the outset or from time to time. In other words, autonomy leads to better decision making in the long run, and in this sense maximizes welfare. Thus reconstructed, the argument for expressing autonomy in various forms of participation and self-governance complements the economic argument for contractualism rather than competes with it. The philosopher's argument looks (speculatively) for welfare enhancement in a whole system of relationships over time. The economist's argument emphasizes the reasons for expecting welfare enhancement in particular transactions.

No doubt some partisans of autonomy as a guiding normative principle will bristle at my consequentialist reinterpretation; they will say that it misses the point of their perspective. I can only respond by offering an observation that risks amplifying the insult, but is not in-

tended to do so. I think an important, and sometimes socially valuable, psychological function is served by the tendency of people faced with probabilistic but uncertain consequentialist arguments for a norm to deny the relevance of such considerations and to seek comfort and resolve in empirically nonfalsifiable moral abstractions. A sense of certainty, achieved by ruling out the relevance of consequentialist concerns, may prevent the demoralization and frequent changes of course that might ensue from close attention to weak and shifting evidence about the likely effects of various rules. Ironically, a deontological stance may so bolster motivation and stability of conduct that it may sometimes increase welfare better than a fastidiously fact-deferential utilitarian one. I doubt that this is generally so, but I can see diversification advantages to having some people in a society be deontologists (or at least nonconsequentialists).

C. *The Rise of Contractualist Views*

Although the academic debate about corporate law is our starting point, it is important to realize that contractualist views have gained prominence in other areas. For example, in recent years the most important theoretical writing about bankruptcy and reorganization law has been driven by a contractualist perspective.[36] More generally, with the establishment of the Coase Theorem and debates about it as a virtual fixture in the mental equipment of all legal scholars touched by the law and economics movement, contractualism has tended to pervade much economically oriented legal scholarship, whatever the particular area or topic.[37] And in the realm of moral philosophy, there has been a notable resurgence of contractualist thinking.[38] The insights gained

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36. See T. Jackson, The Logic and Limits of Bankruptcy Law (1986); Baird, A World Without Bankruptcy, Law & Contemp. Probs., Spring 1987, at 173; Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857, 859–71 (1982); Jackson & Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75 Va. L. Rev. 155 (1989); Eisenberg, Commentary on "On the Nature of Bankruptcy": Bankruptcy and Bargaining, 75 Va. L. Rev. 205 (1989); Roe, Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics, 75 Va. L. Rev. 219 (1989); Scott, Through Bankruptcy with the Creditors' Bargain Heuristic (Book Review), 53 U. Chi. L. Rev. 690 (1986) (reviewing D. Baird & T. Jackson, Cases, Problems, and Materials on Bankruptcy (1985)).

37. The Coase Theorem suggests that, under certain conditions, legal entitlements may not matter much to the allocation of resources, since if the legal rules are inefficient the affected parties will have an incentive to bargain around them to achieve a better arrangement. This way of thinking naturally tends to highlight the importance of contractual rule making and the possibility that it may negate or dominate rules laid down by governmental bodies, i.e., elites. The relevant literature is quite large. For brief overviews, see J. Coleman, Markets, Morals and the Law 67–81 (1988); A. Polinsky, An Introduction to Law and Economics 11–14 (2d ed. 1989).

38. The landmark contribution was, of course, J. Rawls, A Theory of Justice (1971). One of the most notable later efforts is D. Gauthier, Morals by Agreement (1986); for an insightful assessment, see J. Coleman, supra note 37, at 311–42.

from a critique of contractualism in corporate law may inform our thinking about these and other areas as well.

IV. Elitism Disguised (But Powerful)

A. *The Pros and Cons*

The best argument for heteronomy is that elite rule makers may in fact have much better information about what would really promote the welfare of the subjects of a rule than the subjects themselves do. Is it plausible that this situation obtains more than sporadically? Many contractualists seem to assume that the answer to this question is no. But in many contexts, the most plausible answer is a resounding yes. This is likely to be true when technical information is highly relevant to the choice of a welfare-enhancing rule, there are specialists or experts in the technical information, and the judgments made by the experts cannot be rationally second guessed by nonexperts unless they take on enormous costs to become experts themselves. The Food and Drug Administration decides what are and are not safe medicines. It may make lots of mistakes, but ordinary users of medicines are quite unlikely to do better on their own.[39] Similarly, an important asymmetry may exist when the factual beliefs most relevant to choice of a rule are of a general and judgmental sort that depend on experience, and more and wider experience does tend to produce better judgments. Arguably, for example, the staff of the Securities and Exchange Commission may have a better based belief than do most individual shareholders about whether charter amendments to create dual class common stock are often in the best interests of shareholders.

The reality and massiveness of technical and general knowledge, especially in an increasingly complex and specialized economy, deserve to be emphasized, partly because some antipaternalists follow the odd strategy of arguing against paternalistic regulation on the ground that it is unlikely that regulators know better than the regulated what is in their interests. This is an odd strategy because the reason given for

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39. Contractualists with a deregulatory bent may be quick to point out that the existence of real and relevant technical expertise does not necessarily mean that it is a good idea to have government make rules binding on private parties. For example, one could argue (implausibly, in my view) that consumers would be better off if the Food and Drug Administration (the "FDA") had no power to keep drugs off the market or prescribe appropriate and inappropriate uses for them, and consumers relied more completely on their physicians' expert judgments as to what medicines should be taken. I do agree with the general point: the existence of real and relevant technical knowledge does not by itself imply the desirability of rule making by the legal system. But I would emphasize that jumping from the arms of the FDA into those of physicians does not represent an escape from heteronomy. In terms of my categories of normative systems, it would simply be a shift from rule making and sanctioning by the legal system to rule making and sanctioning by a social system, which uses different but potent sanctioning techniques (social approval and disapproval versus legal proceedings). In either case, the patient foregoes autonomy.

resisting paternalism—no information asymmetry exists—is desperately implausible in many real-world contexts, and because much better reasons for resisting paternalism can be offered.[40]

Indeed, the point about elite rule makers' possible superiority with respect to information must be broadened. It is not only that the elites may have access to more and better information relevant to rule making. Elite rule makers may sometimes be better processors of whatever information is available, because of their intrinsic or acquired abilities, or because they are specialists who have the time to focus more carefully on available information, thus reaping economies of scale in its use. Whether elites do have superior information-processing skills will depend on the particular set of institutions and practices prevailing in a society. Bureaucrats in one country may be the cream of the intellectual crop, but in another they may be drawn from groups that have lower average ability than top decision makers in private organizations. Even in the latter case, the bureaucrats' lesser intrinsic skill may be more than compensated for by greater access to information and specialization in its analysis.

The biggest drawback of elite rule making is imperfect incentives. The legislator, judge, or regulator really does not and cannot care as much about the true welfare of *A* and *B* as the latter themselves do.[41]

This point has nothing to do with the reality and extent of "genuine" altruism—another odd and pointless hangup that pervades much of the literature about paternalism. In all real world normative systems—legal systems and religions are the clearest examples—most elite rule makers are heavily motivated to do what they do by way of making rules for others by considerations of personal gain. Legislators and judges work for a salary and hope for approval and esteem; priests, ministers, and rabbis are often supported by others as a result of their religious activities, and many hope for spiritual rewards in this or another life, which in their minds are very real. That these are the ulti-

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40. The literature on paternalism is vast. Studies taking an essentially antipaternalist stand include J. Feinberg, Harm to Self (1986); J. Kleinig, Paternalism (1983); D. VanDeVeer, Paternalistic Intervention: The Moral Bounds of Benevolence (1986); Shapiro, Courts, Legislatures, and Paternalism, 74 Va. L. Rev. 519 (1988).

Writers defending paternalism or at least arguing for a more neutral stance include Kelman, Choice and Utility, 1979 Wis. L. Rev. 769, 769–72; Kennedy, Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power, 41 Md. L. Rev. 563, 624–49 (1982); Sunstein, Legal Interference with Private Preferences, 53 U. Chi. L. Rev. 1129, 1169–72 (1986); see also Clark, The Soundness of Financial Intermediaries, 86 Yale L.J. 1, 17–21 (1976) (finding an irreducibly paternalist basis for much regulation of financial institutions); Kronman, Paternalism and the Law of Contracts, 92 Yale L.J. 763 (1983) (offering principles for evaluating paternalist restrictions on contractual freedom).

41. The same can be said about elite rule makers in the nonlegal systems of social control: religious functionaries in religious systems; neighborhood gossips and informal opinion leaders in small social groups; the village elders in tribal societies; and even the opinion leaders in organized markets.

mate motives by no means implies that the purposes sought to be achieved by such elite rule makers may not include the purpose, when making particular rules, of furthering the best interests of the rules' subjects. Indeed, many thoughtful people might judge it better to be ruled by a competent bureaucrat who promulgates welfare-enhancing rules simply because it is his job to do so than by a charismatic leader who thinks he is endowed with a consuming altruistic vocation. Institutionalizing public-regarding activities in defined rule-making jobs and shaping them with pay incentives and accountability mechanisms may serve everyone better than an increase in other-regarding spirit.

Nevertheless, there is an inevitable lack of identity between the interests of elites and the interests of those subject to their rules. There is, in the language now familiar in the corporate law context, an "agency costs" problem.[42] Or, to follow the traditional distinction in corporate law, elites may not live up to the standards of care and loyalty toward their beneficiaries that would be optimal for the latter. Rule makers may not work hard enough, and they may be corrupted into using their power to pursue other interests, such as their own.

Furthermore, there may be imperfect incentives in the system by which elites obtain power. As a result, those who get to positions of power may not be those who have the expert or general knowledge which might justify heteronomy.[43] It does little good if there are some village elders who really do understand what makes a good life better than the younger generation does if those are not the elders who get onto the village council.

Despite the agency costs generated by elitism and the unavoidably imperfect alignment of incentives that bring them about, elite rule making may have net benefits for rule subjects. There is no a priori reason to preclude the possibility that the informational advantages of elite rule making may outweigh the agency costs it creates, at least in some contexts. In a complex and differentiated society, one might even expect these contexts to make up an ever larger set. But whether or not there is such a trend, there simply is no conclusive argument for an

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42. "Agency costs" arise whenever one person undertakes to act on behalf of others. The principals incur costs in monitoring the agent, to see that she does not slack off or abuse her power for personal ends but lives up to the undertaking, and in taking action to enforce the undertaking, if necessary. The agent incurs "bonding" costs, that is, costs involved in trying to guarantee performance or reassure the principals. And there are the residual costs of unpoliced imperfect performance on the part of the agent. Contemporary corporate law scholars often apply this analysis to the relationship between managers (the agents) and shareholders (the principals). See Jensen & Meckling, supra note 9 (seminal paper on agency costs theory); Brudney, supra note 25 (critique of agency cost theory); Clark, supra note 25 (same).

43. Recall the Peter Principle: Those who do their jobs well get promoted, and so rise to the level of their incompetence. L. Peters & R. Hull, The Peter Principle 25 (1969).

exclusively contractual perspective, even one with an externalities proviso.

B. *Pro-Mandatory Commentators: Elites in Subjects' Clothing*

Now, many law and economics scholars have difficulty facing up to the full import of these simple but important realities. They simultaneously profess to be against paternalism (one form of elitism, as we shall see) and in favor of contractual rule making, but in favor of government regulation to correct market imperfections and collective action problems, which in turn may be thought to stem from transaction costs. This common stance is full of latent tensions, as the current debate over mandatory corporate law rules attests.

Thus, self-professed adherents of a contractualist perspective on the firm do not seem fully aware of the fact that they essentially do allow or even urge paternalistically elite rather than contractual rule making, or of all the complications that may flow from their recommendations. For example, Lucian Bebchuk, in his discussion of the mandatory role of corporate law, starts out by rejecting the view that "the contractual view of the corporation" entails complete freedom to opt out of standard rules and proclaiming that he will show that "the contractual view of the corporation offers strong reasons for placing significant limits on the freedom to opt out."[44] In an earlier paper begun with similar assertions, he had concluded, inter alia, that with respect to some issues, buyers of stock do not have information about the initial charter's provisions that is as good as that possessed by some public officials and, therefore, the proposition that legal intervention cannot improve their situation no longer holds.[45] This view implies that those who do the legal intervening—elite rule makers, in my terms—have made a judgment that they possess something better than the less than full information which the potential subjects of their rules have, and that this self-assessed informational superiority justifies them in imposing nonwaivable rules on their subjects. At the very least, this position raises questions about what it means to be "within the contractual view."

In Bebchuk's article, the procedure for determining which rules should be nonwaivable is to imagine what rational and well-informed shareholders and managers would agree to in a hypothetical contract that dealt with the question of nonwaivable rules of their relationship.[46] Quite clearly, the hypothetical contract is not something observed in reality but something thought or imagined by the elite rule makers.

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44. Bebchuk, supra note 25, at 1822.

45. See L. Bebchuk, Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law 50-62 (Discussion Paper No. 46, Program in Law and Economics, Harvard Law School, August 1988).

46. See, e.g., Bebchuk, supra note 25, at 1824, 1849 (statements of the principle), 1835-58 (execution of the hypothetical bargain analysis).

The latter, not the rule subjects, get to decide how the bargaining comes out. They, not the subjects, get to decide what counts as "rational." As noted earlier, they also get to decide whether subjects have "adequate" information. Because information comes in degrees, not in packets that are prelabeled "full" or "not full," and may generate widely differing estimates of its value in relationship to the cost of getting it, the elites' power to decide for their subjects what counts as adequate information is a very significant one.

Similarly, Ronald Gilson, in urging that dual class common arrangements should be allowed if adopted in charters before initial public offerings are made, but outlawed if sought to be accomplished by midstream charter amendment proposals, essentially favored having the SEC, not investors, decide what will count as a real or valid decision by investors.[47] John Coffee, in discussing the opting out problem in more general terms, starts by asserting that he will take the contractual perspective even more seriously than the strong-form contractualists do, but eventually recommends, in effect, that a group such as the American Law Institute should decide which rules managers and shareholders may decide to opt out of.[48] Both authors appeal to elite rule makers as ultimate arbiters. True, the elites in these cases are called upon to lay down what might be called a meta rule, one that determines the permissible sphere of contractual rule making. But it would be wrong to say that the elites are "only" given power to make meta rules, both because the scope of private rule making was the main issue at controversy in these instances and because the elites are invited to make the default rules, some of which will be nonnegotiable.

In sum, to the extent that elite rule makers set the boundaries of permissible contractual rule making, there is heteronomy rather than autonomy; there is rule by elites rather than contracts. Moreover, this power is not a peripheral excrescence, but a central and important fact. It could only be forced back into the "contractualist perspective" by the fiction of an imagined social contract by which subjects agree to be ruled by elites—a grand move that raises many familiar problems of political theory and that, so far, has not been relied upon explicitly by most corporate law scholars.

C. *Elites as Fiduciaries: The COPE Strategy*

Why do contractualist scholars gloss over their own appeals to elite

47. Gilson, supra note 19, at 840–43. The SEC eventually adopted this approach in its Rule 19c-4, 53 Fed. Reg. 26,394 (1988) (to be codified at 17 C.F.R. § 240.19c-4).

48. Coffee, supra note 25, at 924, 970–74. Admittedly, Coffee seems to have meant, by asserting that he would take the contractual perspective more seriously, simply that he would build upon the fact that general contract law already imposes rules that cannot be waived. But this analogy only reinforces my point here. It calls attention to the important role that elite rule making has in more rudimentary spheres of supposed private ordering.

rule making? An important factor is that, at least among law and economics scholars, the prevailing implicit belief as to what counts as legitimate or desirable heteronomy is so "in tune" with contractual rule making proper that its separate identity is easily ignored. The prevailing belief is what I will call contractually oriented paternalistic elitism, or COPE.

This jargon demands some explication. Elitism, as described before, is the condition in which rules of conduct are actually created and imposed on rule subjects by contemporary elites. I refer continually to elites rather than to "government" because it is not the case that all important elite rule making is done in legal systems. Legislators, judges, regulators, and even the ALI and influential law professors count as elites.

Elitism comes in a number of varieties, depending on the purpose that elites try to achieve when they lay down rules. Redistributive elites impose rules designed to transfer wealth from one group of subjects to another, e.g., from shareholders to managers or vice versa. Public-interest elites adopt rules designed to increase the general public welfare without necessarily improving that of the parties subject to them. Self-serving elites enact rules aimed at advancing the welfare of the rule makers at the expense of those subject to the rules. Finally, paternalistic elites adopt rules the purpose of which is to enhance the welfare of those who are subject to the rules.

Paternalistic elites might themselves follow differing methodologies in trying to decide which rules are in the best interests of their subjects. An older method was simply to predict what the effects of the rule would be, and evaluate them as good or bad on balance for the subjects. The paternalist might have his own firmly held theory of what is really good for the subjects. To the extent that he felt a need to consider the subjects' preferences, he might simply resort to his general impressions of human nature, perhaps refined by any available data about what the subjects think they want. But the more modern paternalistic approach is to follow a special heuristic: imagine a hypothetical contract between the relevant subjects, e.g., all shareholders and all managers, on the assumption that such parties are rational, well-informed (i.e., the fictional bargainers have exactly no more and no less information and knowledge than the elitist who imagines the bargain), and able to bargain free of transaction costs. This procedure, which arguably imposes a more definite structure on the elites' thinking than did the more free-form injunction to consider good and bad effects, gives rise to contractually oriented paternalistic elitism. Most of the commentators who urge a mandatory role for corporate law are implicit advocates of COPE.

Obviously, COPE seems to be an extremely mild way of exercising power, at least in principle and by comparison to other forms of elite rule making that we have observed throughout history. It is hard to

imagine a more respectful form of elitism. A little more respect for autonomy, and elitism might as well immolate itself. It is not surprising that commentators who live in its spirit pay it no heed, and find little tension between their contractualist claims and their actual practice. But the reservation of power to decide what the masses will be permitted to decide is the tell-tale sign. We are in the realm of heteronomy, not autonomy.

Another way of describing COPE is to say that it enjoins elites to act as fiduciaries toward their rule subjects. But even to state the description this way should bring to the mind of every corporate law theorist the now familiar dark side: fiduciary relationships always generate "agency costs," and agency costs are not trivial.

D. *The "Last Say" Objection*

One likely objection to the line of reasoning developed above is especially instructive, in that proper consideration of it may lead us to broaden, not reduce, the thrust of the analysis. It may be said that it is unfair to refer to rule making as elitist when the subjects of the rules have the last say, that is, if they can waive or overturn the rules, as is often true in the corporate law context.

As stated, this approach ignores the fact that the subjects' ability to have the last say is something that may be placed along a broad spectrum. In virtually all governance situations it is abstractly possible for the subjects to have the last say. In a real sense, all rules are default rules. What varies, and what is extraordinarily important, is the cost of having the last say effectively. Consider four sorts of examples. First, the subjects of loathsome rules laid down by despotic rule makers could change them by bloody revolution and extermination of the rule makers. Such a thing is possible and indeed happens. But it is very costly, and no one would think to say that the possibility of revolution negates the elitist nature of the despot's rule.[49] Second, citizens in a representative democracy can vote legislative rule makers out of office. This too happens, but it is very costly and complicated: the impulse to change the lawmakers to protest a particular law faces collective action problems, intertwined issues, and the like. Third, citizens may be able to invoke a referendum procedure to negate a specific law. This too is costly, but less so than the two previous methods. Finally, and still going toward the less costly end of the spectrum, a law may by its terms allow specific individuals or groups to opt out of it by following pre-

49. I realize that bloody revolution may seem too extreme and distracting an example of having the last say, and that the reader may be tempted to remark that it is different in kind from my other examples, such as voting elite lawmakers out of office. The examples are different in significant ways. But I do think it is theoretically important to see that they are also located on a single dimension: the costs to one potential rule maker of trumping another. And this perception is key to understanding what it ultimately means to say that one form of rule making is prior to or dominant over the other.

scribed procedures. This allows relatively low cost trumping of elite rule making by those who are most directly affected by it, if and when they perceive an adverse impact.

Even expressly waivable laws present differing levels of cost, depending on the permitted methods of opting out. If corporate law permits managers to propose midstream charter amendments that would change fundamental shareholder rights, shareholders will face a relatively high level of costs in trying to deal with the collective action problems facing them. If the law only permits a certain nonstandard provision when it appears in the charter that a company has as it goes public, and each individual investor can choose to accept the provision by buying into the company or not, then shareholders as a class avoid some significant problems and costs.

Yet in all the cases mentioned in the last two paragraphs, it is important to keep in mind that (1) elites formulate and lay down the default rules; (2) there is always some cost to the subjects of trumping the elites' default rules; and (3) this level of cost demarcates an area within which there is a risk of stable but welfare-decreasing rules.[50] (Such rules may come about because the elites did not act to increase others' welfare or because they made a mistake.) The transaction costs of trumping help determine the amount of risk from harmful elitism.

One way of thinking about moves toward rules that allow easy opting out is, of course, that they are attempts to reduce this risk. But such attempts should not divert us from a more comprehensive examination of the pros and cons of elitist rule making. It is not the case that any movement toward more easily waivable rules is probably good. The risk that elites will impose welfare-decreasing rules that are costly to trump is only one relevant risk. There may be offsetting considerations, such as the risk that private parties will adopt welfare-decreasing rules by mistake, or because they have (shortsightedly?) gotten themselves into situations where they are subject to collective action or "gaming" difficulties.[51]

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50. As a matter of completeness, it should be acknowledged that the cost level of trumping also demarcates an area within which there may be stable, but welfare-increasing rules. That is, the costs of changing elite rules may sometimes protect the rule subjects from mistakenly changing the rules to their own detriment. Or, to put it another way, the fact that rule subjects can not costlessly change elite rules they do not like is not necessarily an argument for a policy of limiting elitism. In certain contexts, this fact may point toward an opposite policy.

51. One is tempted, incidentally, to wonder why shareholders are not considered to have "consented" to the "distorted choice" situations and "collective action problems" so favored by reformist commentators (including myself) as a basis for regulating managerial or shareholder action. Surely investors who buy stock either have some general sense that such things can happen to them or choose not to investigate far enough to come to such realizations, thinking the cost of further research is not worth the likely benefit. Why protect them from the otherwise ensuing consequences of their decision? If the answer is that the investors' presumed consent is not sufficiently real and in-

Similar points may be made about the paternalism of COPE. One might object that an elite rule maker is not "really" paternalistic if he intends to refrain from or revoke his paternalistic act, or the paternalistic rule he is laying down, if the subject objects—that is, explicitly refuses consent to be bound by the rule.

But willingness to respect the subject's refusal to consent is not a sharp concept with sharp boundaries. Where the line is drawn may be extraordinarily important. Suppose the elitist says, "I hereby lay down a law: Everyone driving an automobile must wear a seatbelt. But I won't enforce this law against any person who explicitly objects to the law and gives informed consent to the risk of injury arising from not wearing a seatbelt." Is this a paternalistic stance? I say yes, if the elitist insists on being the one to decide what are the criteria of decisionmaking capacity and possession of adequate information. True, if the elitist is ready to concede that 95 percent or more of all adults have sufficient "capacity" to invoke the exception because only those with extremely low IQ's, severe schizophrenia, and the like will be found disqualified, and if he deems people adequately informed if they have merely had access to television shows that note experts' belief that seatbelts save lives, then one could say the lawmaker is a "weak" paternalist.[52] But the reservation of power to decide what counts as informed and capable consent is theoretically critical, and may often be practically important.

E. *Conclusion*

My purpose in this section was not to fault contractualists for condoning some elitist rule making, or to fault antipaternalists for condoning some paternalism. As indicated at the outset, my view is that paternalistic elitism may have decisive relative advantages over contractual rule making in a wide variety of contexts. A good society depends on both autonomy and heteronomy, each present in large measure. Theorists ought to face up to this point and then see what headway, if any, can be made in devising principles for setting the optimal mix.

V. TRADITIONS IGNORED (BUT PERVASIVE)

A. *Some Examples and Types of Traditions*[53]

Consider some examples of traditional rule following. First, judges follow case law precedents most of the time. This proposition

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formed, that answer simply underlines the point that it is the elites who arrogate the power to decide what counts as a decision.

52. A better description might be that he is a restrained paternalist.

53. The best book-length treatment of traditions in general may be Edward Shils, Tradition (1981). His account contains many illuminating observations, although it does not try to impose the specific analytical structure that my brief one does. One of his major themes, that Max Weber was wrong in thinking that the rationalization process

should be obvious, but its enormity and significance may be obscured in the minds of many observers of legal process: professors who regularly read law review articles (usually dealing with how the law should be), law students who have feasted on a diet of leading or unusual cases and interested intellectuals who are exposed to newspaper accounts of "hot" areas like insider trading and takeover defenses. But almost any close look at the background landscape instead of the attention-getting foreground reveals a very different picture. If, for example, one does a Westlaw search of all published opinions handed down by state and federal courts in the United States during the past two years that contain the phrases "pierc[ing] the corporate veil" or "alter ego doctrine [or theory]," one will discover several hundred opinions, most of which use the corporate law doctrines rather than make mere passing reference to them. A reading of the cases will show that very few of these opinions are devoted to determining what the proper corporate law rule in this area should be. To the extent that there is reasoning, it is reasoning about what the received rule "is" and how it applies to the facts found by the court. Reasoning about what the rule is usually occurs (1) when a particular jurisdiction has multiple and slightly varying precedents, in which case it takes the form of synthesizing, restating, and perhaps reconciling verbal formulations, or (2) when a jurisdiction has too few precedents, in which case reasoning takes the form of looking at the precedents in other states and perhaps at the generalizations of case law offered by descriptive commentators.[54] Most opinions do not do such reasoning. And very, very rarely do courts engage in anything like an analysis from first principles of what the rule should be (e.g., an extended discussion of a hypothetical ideal bargain among rational and well-informed managers, shareholders and creditors). A similarly comprehensive search of case law in other standard areas of corporate law doctrine—rules about taking corporate opportunities, basic self-dealing and the authority of corporate officers, for example—will show a similar result. For the most part, the courts simply follow the rules laid down by other courts in the past, and they display no particular interest in the deep structure or the true rationale of the rules. None of this should be surprising, of course. If courts acted otherwise, the judicial system would be extravagantly and pointlessly more expensive than it is.

Two other examples of traditions will recall how broadly pervasive the phenomenon of traditional rule following is and allow us to distinguish between two important types of traditions. First, consider the technical, instrumental rules of the building trades. Even the most ordinary house results from a set of construction activities that are guided

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characteristic of modern times would work steadily and uniformly toward a traditionless society, is similar to the argument I will make.

54. For a full and richly textured account of how rules are established in a judicial tradition, see M. Eisenberg, The Nature of the Common Law (1988).

by literally thousands of traditional rules of practice. Most of these rules were the result of a conscious assessment by someone in the past of the consequences of alternative practices and of their costs and benefits. Yet present contractors and workers mostly follow the rules rather than make them or "choose" to follow them. The carpenters place rafters no more than 16 inches apart, and use wood no smaller than two by eight inches wide.[55] They understand in a rough way why these guidelines exist, but usually do not have anything like a precise knowledge of what would happen if they deviated from them to this or that extent. The plumbers know that they ought to install P-traps under every drain,[56] but some of them may not even have an accurate general knowledge of why this requirement exists (to create a water barrier that will prevent backup of disease-carrying sewer gas).

Second, consider customary rules concerning sexual behavior and marital relationships. Such rules may serve important positive functions. At least in some cultures, rules enjoining monogamy and forbidding adultery may enhance the group's ability to compete and survive. The rule enjoining monogamy may promote greater cooperation among males. The rule forbidding adultery may enhance family stability and result in better child-rearing. Even to suggest these possibilities, and then to consider the controversial social science literature that may bear on their assessment—studies on whether children of divorced parents fare as well as children of stable families, for example—is to appreciate how difficult it is, even in a highly rationalized society, to make a good judgment about what rules would actually enhance welfare. Nevertheless, it could be that traditional rules of conduct have positive value, at least as compared to many alternatives, because they have been selected over time. Groups possessing good customary norms about important matters may fare better, relative to others. They may grow faster, compete better in war and trade, and be perceived by opinion leaders as "working" better. These effects may follow even though none or few members of the group may have an accurate understanding of the functions of the relevant rules, and even though the rules were originally adopted for opaque or misdescribed reasons.

These latter two examples suggest a distinction between polar types of traditions. I will label them technical traditions versus organic traditions, even though these labels do not fully capture the distinction. Technical traditions result from an accumulation of numerous consciously purposive decisions made by particular rational actors in the past. Organic traditions are composed of rules that seem to be functional, or at least partly so, but that have evolved over time without their effects being fully and accurately understood by any individual

55. See, e.g., J. Wilson, Practical House Carpentry 125 (1973) (stud separation).

56. See, e.g., T. Hicks, Plumbing Design and Installation Reference Guide 5-7 (1986) (using term "house traps").

person.[57] Such traditions, to the extent that they "work," seem to have been sifted and shaped over generations by feedback processes whose exact nature is only dimly discernible. They have been subjected to something resembling natural selection.[58]

With either type of tradition, those who follow their rules usually do so without a full and critical awareness of the reasons for the rules. In the case of technical traditions, this happens because of the sheer information processing limits of individual human brains. The amount of received lore is enormous; it is hard enough to find the rules or models relevant to one's specific task. Mental power is limited, and life is too short and full of alternative tasks yielding a higher value for one's efforts than reexamination of traditional lore. Consequently, very few who use a technical tradition will find it sensible to try to master all its parts and all its reasons. In the case of organic traditions, rule followers do not acquire a full and accurate appreciation of the rationale of the rules because virtually no preceding individuals ever did, and it is too hard to fathom them.

In both kinds of traditions, followers may assume that the tradition embodies wisdom, even though it is not fully articulated to them. Their faith is often based on some appreciation of the kinds of persons and processes that have contributed to the formation of the tradition. If the village elders have applied these principles since time immemorial, and most people have found them satisfactory, then they are probably good. If these techniques of construction, plumbing and electrical wiring have been used by workers and contractors for many years, and buildings made with them have been generally successful, there is little point in approaching them in a critical or doubtful spirit; instead, they will be treated as good until clearly proven otherwise. If my religious group has long followed certain rules concerning marriage and adultery, I will try to follow them, since the group over time seems to have consisted of good people who have fared well and been inspired by God to follow these principles. Similarly, lawyers and judges tend to have a faith in the essential goodness of judges who have, over time, built up the body of precedents they have received.

To be sure, following a tradition may also be based on something much more instinctive than a meditation upon the people and process that produced it. It may be that most people simply have a strong,

57. Or, if they were so understood—by, say, the extraordinarily astute founder or promoter of a new religious movement—the understanding of the rules' rationale has not been communicated effectively to later generations of followers.

58. There is, of course, a long history behind the view that the superiority of tradition to ratiocinated principles lies in the accumulation and testing of experience over generations. The classic statements of this view include Cicero, De Republica (C. Keyes ed. 1928); E. Burke, Reflections on the Revolution in France, *in* 3 Works 356–57 (3d ed. 1869); and F. Hayek, The Three Sources of Human Values, reprinted *in* 3 Law, Legislation and Liberty: The Political Order of a Free People 153–76, esp. 168–69 (1979).

evolved, biological instinct to do what a certain majority of other people in some relevant reference group are doing.[59] They may also tend instinctively to imitate high status people.[60] Whatever the ultimate basis, imitative behavior of either sort is a real and important phenomenon, and it probably helps account for why people follow traditions.

Technical traditions may, but need not, lend themselves more readily than do organic traditions to rational reexamination and improvement. By definition, such traditions result from a large accumulation of purposive decisions taken by others in the past. If (but only if) the bases of those decisions have been memorialized in some way, then they may be retrieved and compared to the reasoning behind some proposed improvement to the tradition's rules. In many real-life technical traditions, the reasoning behind the adoption of past rules is not fully and conveniently documented or memorialized, so that rational critique faces nontrivial costs and risks.

With organic traditions, rational critique is more difficult than for reason-memorialized technical traditions. The critic has two tasks: she must postulate a supposed real reason for a particular rule and then show how a particular alternative rule would probably lead to better results. Either part of the exercise may be flawed, but it is peculiarly difficult for discussants of the critique to assess whether there has been a flaw of the first type, that is, a misidentification of the real reasons for the traditional rule.[61]

Many traditions have a hybrid character: they are both technical and organic. The systems of ethical rules developed by the world religions often do have a technical side, which may be extensively documented, as in the Talmud or in the writings of Catholic moral theologians, but there is also a substantial organic component. The common law tradition tends more toward the documented and technical pole, but even its rationale is not completely documented and undoubtedly has important nonconscious elements.

B. *The Pros and Cons*

1. *The Informational Advantage.* — Consider now the economic logic of traditions—their characteristic benefits and costs. The biggest advantage of traditional rule following, as opposed to either contractual

59. For an elaborate attempt to model this view and support it with evolutionary arguments and empirical evidence, see R. Boyd & P. Richerson, Culture and the Evolutionary Process 204–40 (1985) (ch. 7, "Frequency-dependent Bias and the Evolution of Cooperation").

60. See id. at 241–79 (ch. 8, "Indirect Bias and the Evolution of Symbolic Traits").

61. In addition, the critic of a traditional rule may be faced by the charge that the rule embodies a "core value" of some sort, so that any search for a supposed real reason of a subtler sort is fundamentally misguided. The objection recalls the position of philosophers who value autonomy in and of itself, see supra text accompanying notes 34–35, and generates a similar debate.

rule making or elite rule making, pertains to the information dimension. Traditions greatly reduce the very high costs of repeated discovery, learning, and rational decisionmaking by individuals. To identify the most plausible alternative rules for a situation; to analyze the possible consequences of each rule and evaluate their probability; and then to place values on the predicted consequences and rank the options—all of this takes great time and effort to do well. Once done, it is far more expedient for others faced with a similar situation to copy the result than to reinvent it.

Two explanatory comments are worth making about the informational advantage of traditions. The first is that the advantage may be a massive one, so great that even a very large accumulation of the characteristic tradition-related costs (discussed below) may fail to erase the tradition's net advantage. The enormity of the costs saved by social learning (imitative behavior and traditional rule following) relative to repeated individual learning needs to be emphasized simply because the costs generated by a tradition reflect more interesting and salient phenomena than the tradition's quiet advantage, and are apt to occupy a disproportionately large share of attention.

The second comment is a comparison among sources of rules. Contractual rule making does or should flourish when local information is most relevant to the choice of an optimal rule. Paternalistically elite rule making does or should flourish when substantial technical expertise or experienced judgment about general matters is most relevant. Traditional rule following flourishes when the parties' situation is similar to one covered by a received rule in an adequately respected tradition, for it operates to eliminate the need for new information gathering and processing. Within the domain of repeated transactions governed by a rule in a respected tradition, traditional rule following will dominate contractual rule making and elite rule making, at least in terms of the information dimension.

2. *The Muting of Imperfect Incentives.* — Consider now the incentives dimension. Here tradition appears in a middle ranking. From the point of view of a rule subject assessing the likely goodness for his own welfare of the incentives that led to adoption of a particular rule, a traditional rule is not as good as an autonomous or self-imposed rule (such as one adopted in an actual express contract). But it may well be better than a rule adopted by contemporary elites. This is so because tradition offers both diversification advantages and more time for longer term corrective mechanisms to work. Today's elite—the particular set of people on the bench and in the legislature, for example—may happen to have class allegiances or base motives that lead them to adopt rules contrary to the best interests of those subject to such rules. It is less likely that this disparity of interests existed with respect to all past generations of rule makers who have contributed to the formation of the tradition by defining, refining, adjusting, and reshaping its par-

ticular rules. The traditional rules are more likely to reflect an averaging process than are rules adopted from scratch by today's elite: less likely to be extravagantly beneficial to a particular subject (at the expense of other persons disfavored by the elite), but also less likely to be especially harmful to that subject. The tradition embodies less risk.

Similarly, an imperfect rule adopted long ago by elite rule makers (say, a statutory rule based on a mistaken perception of facts or causal relationships) may have been partly "corrected" in the intervening period (say, by judges who have read "implied" exceptions into the rule).[62] The whole set of traditional rules should present less risk of uncorrected, mistakenly motivated rules than a comparable set adopted de novo by today's elite.

3. *The Bad Side Effects.* — The biggest costs of traditional rule following are side effects of the learning process that is necessary to achieve tradition's informational advantage. Learning and following a traditional rule is a form of social learning, as opposed to individual learning. Broadly construed, "social learning" refers to all sorts of imitative behavior. A precondition of such learning is that there be a fair degree of gullibility or docility on the part of followers.[63] "Individual learning" refers to independent discovery by an individual of desired patterns of behavior, whether by means of trial and error learning (such as behavioral conditioning) or by means of individual cogitation about the likely consequences of different actions. Social learning in general, and traditional rule following in particular, imply paying attention and deference to cues in the social environment—What are the practices of the majority or of the high status people, so that I may imitate them? What are the received rules, so that I may follow them?—rather than analyzing and evaluating the consequences of practices and rules, in order to decide for oneself what is best. Social learning—imitative and

62. The correcting process could go in the other direction, of course. An unwise or imperfect judicial decision might be partly corrected by a legislative response. Moreover, a later legislature can revisit an earlier legislature's product in light of experience, and a later set of judges may limit or reshape what was produced by an earlier set in order to suit their own preferences (which might be self-serving, redistributive, or paternalistic). I do not mean to be asserting anything here about the question whether judges are more or less prone than legislatures to adopt welfare-enhancing rules. Nor should I be read as denying that later generations may adjust received rules in ways that decrease welfare. Mistake and evil are both possible and abundant, even in traditional processes. My point about the averaging or risk-reducing quality of traditions rests on an intuition that people affected negatively by a tradition are almost never completely powerless to do something to alleviate their plight, at least in the long run. Over a sufficiently long period of time, they are likely to cause an alleviation. Consequently, following traditional rules over a medium-run timespan such as a lifetime (during which the incentives and biases of elites may change several times) will usually present less risk of especially adverse (or especially favorable) effects on a subject than following rules laid down by each day's elite.

63. See generally R. Boyd & P. Richerson, supra note 59, at 40–60 (discussion of social learning theories, with references to the social-science literature).

following behavior—is often much cheaper than individual learning, because it obviates pointlessly repetitive rediscoveries.[64] At the same time, it generates what might be called "out-of-touch" costs, since the imitators and followers are not trying to monitor the true consequences of their behaviors.[65]

Three types of out-of-touch costs deserve to be noted. They stem from changed environments, copying errors, and failures to innovate. First, people who do not orient themselves to the consequences of practices and rules may fail to track real and relevant changes in the environment, and to adjust the practices and rules accordingly. Many traditional cultures and normative systems retain outdated and vestigial practices beyond the time when they cease to yield a net benefit, simply because no or too few people in power are monitoring changes. Such lags are real; it is only with great caution that one should consider explaining apparently silly rituals and practices by resort to hidden or symbolic functions.[66] The lags reflect the high cost of rational understanding and reevaluation of customary practices.[67]

Second, even without change in the relevant aspects of the external

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64. Obviously, real-life imitation is complicated by the very high costs of discerning and copying subtle aspects of the behavior or practice to be imitated. Many physical skills have a hybrid character. For example, a person's acquisition of the refined motor skills needed to shoot a bow and arrow, drive a car, operate machinery, type on a typewriter, and so on ad infinitum depends heavily on individual learning (of the operant conditioning sort emphasized by B.F. Skinner, see, e.g., B. Skinner, About Behaviorism 44–49 (Vintage ed. 1976)), even though the fact that there are such skills to be learned is clearly a cultural phenomenon—something "inherited" from the culture and acquired in major respects by social learning. The same could be said of each person's "getting the hang" of any number of intellectual skills. More generally, there is usually an irreducible (and sometimes quite large and important) component of individual discovery in social learning. Not all cases, perhaps not most cases, of social learning are like Bandura's famous modeling experiment (where children watching a film of aggressive adult behavior toward dolls later displayed similar behavior, apparently without having to engage in any sort of "practice" to get the hang of the behavior). A. Bandura & R. Walters, Social Learning and Personality Development 61–64 (1963).

65. The essence of this point still holds if we suppose, as seems very likely, that imitators do pay attention to the impacts of their behaviors on the reaction of significant others in their social environment. That is, people may be guided by social cues observed both before and after particular acts. Either way, a heavy reliance on social cues may lead to the costs discussed in the text.

66. A too-easy facility at inventing such explanations may have been a factor leading anthropologists to become disenchanted with the functionalist movement in their discipline. See C. Geertz, Anthropological Approaches to the Study of Religion, *in* 13 International Encyclopedia of the Social Sciences 398, 402–03 (1968); cf. E. Nagel, The Structure of Science: Problems in the Logic of Scientific Explanation 520–35 (1961).

67. The existence of nonfunctional or dysfunctional vestigial rules or practices therefore reflects a rational response to the limits of human information processing capacity, not irrationality. Such vestiges are consistent with the view that human beings attempt to maximize their net welfare. In designing a system to generate useful norms of conduct, a rational person would not want to spend an unlimited amount of resources on monitoring for changes in the usual effects of applying the rules. She would only want to spend an optimal amount, an amount that would minimize the expected value of

environment, the practices passed on by social learning may drift toward less desirable or self-defeating forms, without timely correction. This can happen because there will inevitably be errors in the transmission and copying of information and behavior patterns. Consider a fanciful but prototypical example. Genuine innovators are very rare in an early human society, *X*. One of them, Prometheus, invents social practice *P*, the cooking of meat over a fire before eating it. This practice happens to fit the humans' environment well (it kills bacteria that would otherwise cause illness), even though that is not why the practice is adopted (high status people happen to like the taste of cooked meat, and others imitate them). *P* is imitated and copied by succeeding generations. Because of copying errors, it gradually becomes practice *Q*, the cooking of meat to a crisp before it is eaten. Two hundred years after the invention, the old *P* is still appropriate to the environment, which has not changed in relevant respects (the bad bacteria can still be killed by moderate cooking, which is just as good as overcooking in this respect), and it is even the optimal practice (moderate cooking doesn't cause the same level of cancer risk that overcooking does). By comparison, the actual practice *Q* is inferior to *P*. It is a mutant dead hand that presses down on real welfare.

Third, people following traditional rules and practices may fail to innovate, that is, to invent new practices that will yield an even higher net benefit than the customary ones. For example, followers of the Promethean practice *P* may not bother to discover the practice *R*, stewing meat in a pot instead of cooking directly over a sooty fire, which might have greater net benefits to them.[68]

Distinguishing the three types of out-of-touch costs from one another is useful because social systems evolve somewhat different remedial strategies in response to them. Parodies in plays and literature may help to discipline failures of existing customs to adapt to changed conditions. In sharp contrast, fussy religious scholarship designed to reconstruct and verify the "correct" version of the scriptures and other key documents in a normative tradition may be motivated in part by fear of drift.[69] Similarly, judges and scholars in a legal system may display concern for the original intent of the drafters of a statute or constitution. Failures to innovate may be redressed by creating formal institutions, such as research and development departments in busi-

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the sum of monitoring costs and the costs of lags in reform of outdated rules. Most likely, this would dictate a willingness to tolerate a fair number of lags.

68. The stew might taste as well or better than meat cooked over a fire—this is the aspect an innovator in a prescientific society might attend to—and it might be much healthier because of a reduced cancer risk—an aspect of stewing that such an innovator might not consider. I deliberately use an example involving consequences that are less and more costly to know, in order to suggest how complicated the situation could become.

69. Note also that nonliterate cultures sometimes place an extraordinary stress on exact memorization of huge quantities of orally transmitted lore.

nesses, or by fostering a cult of creativity. Some measures may improve both adaptation and creativity. For example, educational institutions may develop and teach formal courses in logic, epistemology, psychology, statistics, experimental methodology, and other techniques of critical thinking.

Apart from generating the kinds of costs already mentioned, social learning and tradition following make it possible for massive social illusions to arise and persist for many generations.[70] To my mind, the belief systems of the world religions present obvious examples.[71] The persistence of outmoded scientific paradigms may be due to similar processes.[72] Shared illusions in legal systems are closer to home for most readers of this paper, and are therefore harder to identify with confidence, but they no doubt exist.[73] As long as (1) many people in the system are primarily following social cues, and (2) the entry points for new conventional beliefs are imperfect in their ability to screen out

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70. To be sure, independent cogitation may give rise to illusions too. See generally D. Kahneman, P. Slovic & A. Tversky, Judgment Under Uncertainty: Heuristics and Biases 231-48(1982). (Note, however, that many of the typical cognitive errors reported in this volume depend in part on social learning.) And the susceptibility to operant conditioning, though it generally works in favor of an organism that has it, may lead to seriously mistaken or inappropriate responses to some situations. Nevertheless, social learning seems riskier on this dimension because of its capacity for facilitating the spread of illusions among many people. It not only suffers illusions; it broadcasts them.

71. From one point of view—that of the scientist always seeking external evidence—it is puzzling that many religious beliefs could have persisted as long as they did. Even in the Middle Ages, a rational individual with an independent (that is, asocial) turn of mind should have been skeptical of Christian beliefs in an afterlife, angels, eternal reward and punishment, and so forth. In the face of a lack of really probative evidence and in light of the more parsimonious and straightforward inferences that might have been drawn from observations of daily life, how could such beliefs persist? At least in part, because believers felt security in believing what important others around them believed. For the individual, and in the longer run for the society, there was no impetus to be upset by the logical and evidentiary problems in customary beliefs so long as they seemed to "work"—to produce more benefits than costs, on balance. And the immediate criterion for what "works" is, for most people most of the time, what other people in their community believe works.

72. See generally I. Cohen, Revolution in Science (1985); T. Kuhn, The Structure of Scientific Revolutions (2d ed. 1970). Arguably, in its waning years each dominant paradigm hampers the search for a fuller and more precise account of the truth. Obviously, one might balk at labelling as an "illusion" a paradigm that actually does give a reasonably good account of many if not all observable phenomena in a field, and this reservation would apply to both halves of Kuhn's prototypical example of a paradigm shift—that is, to both the Ptolemaic and the Copernican models of the universe. See T. Kuhn, The Copernican Revolution: Planetary Astronomy in the Development of Western Thought 3 (1957). But my main point is not about what precise label to use. The point is that social learning and tradition following have the adverse side effect of sometimes leading people to cling to inadequate views.

73. Consider some assumptions often associated with democratic legal systems: all persons are created equal; government exists as a delegation from the people; and so forth. Depending on how they are understood, these premises might well be classified by a detached observer as illusions, albeit useful ones.

illusions, pervasive and long-lived illusions are possible. And illusions may positively obstruct the search for useful truths.

Finally, significant costs arise because social learning and tradition following (and therefore their many benefits) depend on the fact that most people are predisposed[74] to be fairly docile and even gullible.[75] Gullibility is a natural and socially useful trait, but it breeds parasites. Some humans will exploit the opportunity to defraud others.[76] Over time, social control systems evolve methods to counteract fraud. Notably, all of the four major types of normative systems—legal, market, social, and religious—are centrally preoccupied with it. Defrauders in turn evolve more evasive tactics of exploitation. There occurs, in slow motion, the play of action and counteraction that is typical of strategy in general[77] and that tends to arise whenever there are conflicting interests that cannot eliminate each other.

As suggested at various points above, social systems incur secondary-level costs in their efforts to reduce the primary costs of social learning and tradition following. Ideally, a system would be so designed as to maximize the surplus of all tradition-related benefits

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74. Whether genetically or by cultural conditioning, I need not say. I would note that it is not obviously foolish to see the underlying, very widespread predisposition to gullibility as a result of powerful evolutionary trends. In many (though certainly not all) contexts, it is prima facie a biologically efficient predisposition, compared to its chief alternatives (genetic learning and individual learning). See generally R. Boyd & P. Richerson, supra note 59. It could be the offshoot of an evolutionary advance in human nature, an advance that, like most others, has uncorrected bad side effects associated with it.

75. Of course, no one is completely gullible. Each individual has a mix of propensities to develop behavior patterns by imitation and other forms of social learning (including acceptance of the pronouncements of teachers and of spokespersons for traditions); by operant conditioning of random responses; and by independent thinking about causes and effects. The mix varies across persons. It may also vary significantly across populations. A responsive and innovative society may have a relatively high proportion of individuals who are disinclined to follow the crowd.

Indeed, we must strengthen this admission of the prevalence of innovative tendencies. Social learning, whether by teaching or mere imitation, could never have gotten started unless there were something to be passed on. That something had to be discovered by individuals. Those individuals almost certainly were sensitive to rational reflection or to operant conditioning by their environments. So there is no possibility for social learning to have started except in a population that also contained individuals primed for large amounts of individual learning. There is also no reason to think that the latter trait would ever die out completely after social learning began to be established and gullibility selected as a favorable trait by evolutionary forces. Indeed, the out-of-touch costs discussed earlier argue against such a dying out, since individual learning reduces them. In sum, humans can be dependent on and expert at both social and individual learning.

76. Strictly speaking, the door to fraud is opened wide by gullibility rather than tradition following per se, so it is more accurate to think of increased fraud as a cost associated with traditions rather than a cost generated by them. On the other hand, tradition following may exacerbate gullibility.

77. See E. Luttwak, Strategy: The Logic of War and Peace 27–31 (1987).

over all tradition-related costs. No large-scale social systems are the product of a conscious and coherent rational design, however, and it seems quite doubtful that invisible hand mechanisms exist that would produce an even approximately ideal set of traditions in any of them.

Nevertheless, all the costs of traditions—delayed adaptation, harmful drift, reduced innovation, shared illusions, and increased fraud—must be put in perspective. The cost-saving advantage of tradition following can be enormous, and in a particular system it may easily absorb all these costs with benefits to spare.

C. *Protective Emotions: Some Speculations on Sacralization in Religion and Analogues in Law*

An aspect of traditions that must be explored before we go further is the layer of shared feeling that is often placed over them. Traditional norms are often objects of deep respect in the minds and hearts of those who follow them, just as—in seemingly paradoxical fashion—the preference for autonomous rule making is accompanied by deep emotion on the part of those who espouse it as part of their belief system.[78] By contrast, strong emotion in favor of elite rule making seems relatively rare in our society, at least among the nonelite. Indeed, there is a pervasive feeling that paternalism is taboo, which coexists along with vast realms of essentially paternalistic rule making.[79] How if at all may we make sense of these emotional patterns?

With respect to feelings about traditions, the best procedure is to start with the starkest form of the phenomenon, analyze it, and then try to carry the analysis over to the legal system.

One of the handful of truly distinguishing features of all the world religions is that they demarcate certain things (books, people, places, times, rituals, etc.) as "sacred," that is, as being both worthy of awe and respect and beyond the bounds of permissible criticism.[80] Indeed, some schools of thought in the sociology of religion seem to make a sense of the sacred the essential or defining property of religion.[81]

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78. I am not talking only of those who see autonomy as an end in itself. The preference for contractual rule making among contractual theorists in the law and economics movement often appears not as a cool best judgment, but as a fiercely held belief.

79. See Shapiro, supra note 40, at 529–45, which develops the theme that antipaternalism is indeed a dominant strain in our legal tradition, and Kennedy, supra note 40, at 631–38, which argues that paternalistic rule making is actually quite pervasive. Roughly speaking, I agree with Shapiro's view of the dominant theory and Kennedy's portrayal of the facts. My normative stance on paternalism differs from both of these writers, but resembles Kennedy's in its refusal to adopt an inhospitable attitude.

80. The power of sacralization over believing minds was dramatically illustrated by the Iranian reaction to the publication of Salman Rushdie's "blasphemous" book, Satanic Verses (1988). See Khomeini Urges Muslims to Kill Author of Novel, N.Y. Times, Feb. 15, 1989, at A1, col. 5.

81. See, e.g., M. Eliade, The Sacred and the Profane: The Nature of Religion 11–12 (1959); cf. E. Durkheim, The Elementary Forms of the Religious Life 462 (J.

Much work has been done on the question of what things are considered sacred, and how sacred things are treated in the systems of belief and feeling of religious believers. Unfortunately, relatively little good work has attempted to develop specific theories about how processes of sacralization could ever have gotten started in human societies. The same can be said about theories that would describe in operational terms how and when things come to be regarded as sacred, and how the feeling is spread. The clearest points about sacralization, from an empirical point of view, are that it produces a distinctive emotion and that it has the operational consequence of quelling doubt and criticism.

Thinking about the phenomenon in an evolutionary perspective helps to make more sense of it. As previously pointed out, both social learning and independent mindedness are enormously important for any viable society. Yet the two tendencies will often be at war. Sacralization sets a thick boundary line that keeps the hostilities from ranging too freely and causing chaos. It creates a retaining wall to prevent erosion of core customs by the cloudbursts of reason.

Consider the matter from a slightly different angle. Could it make evolutionary sense for human beings to develop an innate predisposition to regard certain appropriately marked beliefs and practices as worthy of awe and beyond question? A predisposition, that is, to develop a sense of the sacred? Yes, if it were frequently enough the case that individual reason acted too eagerly in its critiques of traditional wisdom. This possibility should not seem an odd or alien one to many readers. Most academics who have observed intellectuals over a long time frame, for example, could probably call to mind a fair number of instances when persons they thought of as half-cocked rationalists—often young, eager, ambitious, and very bright—confidently constructed and promoted clever but somehow unconvincing rationalistic critiques of existing law, customs, theories, and the like. Such critiques, one senses, may be relatively coherent as an internal matter, and may be based on sound evidence and observation, yet may "feel" lacking because they do not seem to consider all the relevant factors. If such feelings are correct—if the custom in a field at least sometimes embodies a higher rationality beyond the grasp of any individual consciousness—social slowness to respond to rationalistic critiques may be a welfare-enhancing trait.

Note that I am distinguishing sharply between (1) the mere habit of following along, based on a predisposition toward social learning—to

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Swain trans. 1965) (division of things into sacred and profane a key idea of all religions); M. Douglas, Purity and Danger: An Analysis of the Concepts of Pollution and Taboo 21-22 (ARK ed. 1984) (commentary on Durkheim). Treating sacralization as the essence of religion results in an outlook on religion that is far too narrow. The better writers, e.g., M. Weber, in his The Sociology of Religion (E. Fischoff trans. 1963), explore a much wider range of phenomena that recur in religions. Nevertheless, sacralization is an important factor in any serious account of the sociology of religions.

imitate others, follow the crowd, and defer to received traditions—and (2) a feeling of reverence for or deference toward aspects of traditional systems that are marked as sacred. The latter is used to bolster or shore up the former. Under my speculation, the feeling probably developed independently of the habit, and at a later time in human evolution. It was not just "there" from the beginning of early human or prehuman society, along with docility. It developed because of its social utility and survival-enhancing properties. It developed in reaction to the disintegrating assaults of individual reason. In a sense, critical reason "created" the sacred.[82]

Inevitably, the sense of the sacred will have an arbitrary character, for the optimal degree and form of resistance to rationalism is difficult to determine. Indeed, it follows almost by implication from the nature of my descriptive theory of the benefits and costs of tradition following that it is beyond the capacity of any individual thinker to say with justifiable certainty what the proper limits are! Traditions contain wisdom beyond the capacity of individual thinkers to grasp;[83] they also generate costs of staggering complexity and elusiveness. The effort to properly reconcile social with individual reason—or tradition with contract, to take the narrower focus that set me onto this topic—runs up against herculean difficulties. A rough and arbitrary boundary line may be the best that we can do.

I turn now to legal systems. Here the most obvious and common analogue to sacralization is the judge's feeling of respect for precedent. Admittedly, it is a rather pale doppelganger of the religious phenomenon. One might say that sacralization in religion is to respect for precedent in law as a glass of whisky is to a white wine spritzer. Nevertheless, the analogy seems well taken. In some fields of law, such as American constitutional law, it is stronger and more obvious. Even relatively progressive judges and commentators seem to display a strong sense—a moral feeling, not just a thought—that the text of the Constitution is quite special and not lightly to be subjected to de novo critique. Similarly, the people and the times in American history that produced the

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82. Alternatively, the sense of the sacred might have come about as a random mutation, perhaps of a more basic or general fear response, and then spread and survived because of its evolutionary advantages. In this scenario, it might have appeared quite early in human or pre-human evolution. In any event, the point of my speculation in the text is only that one may properly be skeptical of accounts that portray critical reason as coming along very late in human evolution, first to question and later to banish and supersede magic, superstition, religious faith, and other forms of pre-rational custom.

83. Highly religious persons have often adopted a similar though more reified line of argument: Sacred beliefs and ethical prescriptions embody a higher wisdom (God's) that is beyond the grasp of humans, individually or collectively. As a result, consequentialist critiques of the beliefs and rules are not freely permitted. Changes can only be made in certain highly limited ways, e.g., as a result of "revelations" to religious leaders of recognized holiness or appropriate official rank. (The history of the Mormons furnishes many nice examples of this process.)

Constitution are often viewed as special and extraordinary: "Those were the days when giants walked the earth." Major disputes seem to be between those who would worship only the Founders (the originalists) and those who would also respect the refinements and changes made by later contributors to the constitutional tradition (the living tradition proponents).[84] The parallel to certain disputes in religions with highly developed theological systems is quite striking.[85] What is noteworthy is that virtually none of the publicly important disputes are between worshippers of either sort and atheists (that is, those who would argue that the Constitution is not at all entitled to special deference, but should be changed freely whenever we think of a better way to do any of the things it governs). Whatever one may think of the depth or form of the jurists' respect for the tradition, one must concede that it is widely felt.

It may not be unreasonable to extend the reasoning in this section to antipaternalist sentiment and to the contractualists' marked abhorrence of noncontractual rule making. Being ruled by contemporary elites, however unavoidable it might be, evokes fear of abuse, and may generate protective emotions. In this case, the major purpose of the emotion seems to be, not just to establish a thick boundary line between conflicting sources of rules, but also to provide constant and unrelenting pressure to push the line in one direction.

VI. Implications

Let us return to the particular problem that launched us into the general reflections of the last four sections. Suppose a corporation attempts a charter amendment excusing directors and officers from the judicially developed fiduciary duty of loyalty. Specifically, the charter amendment declares that officers and directors of the corporation may deal with it without disclosing their adverse interests in the deal to anyone else connected with the corporation, and that any such transaction

84. Contrast Bork, Neutral Principles and Some First Amendment Problems, 47 Ind. L.J. 1 (1971), and Bork, The Constitution, Original Intent, and Economic Rights, 23 San Diego L. Rev. 823 (1986), with L. Tribe, Constitutional Choices vii–viii, 3–80 (1985). It should be relatively obvious that my theory of tradition leads me to agree with those who respect past constitutional adjudication as well as the intent of the framers. It is not apparent to me why there should be any exclusively privileged time or people in the making of any tradition. A major argument for traditions is, as was argued earlier, their averaging or risk-reducing properties, which depend on their being a long run of development by numerous different contributors. It is true and curious that people are repeatedly tempted, in all sorts of traditions, to resort to originalism, but that tendency may be due to psychological factors, such as the inability of most people to appreciate probabilistic processes and reasoning. See R. Nisbett & L. Ross, Human Inference: Strategies and Shortcomings of Social Judgment 15–16 (1980).

85. See S. Levinson, Constitutional Faith 18–27 (1988) (discussing the split within Christianity over the proper roles of scripture and tradition); see also Grey, The Constitution as Scripture, 37 Stan. L. Rev. 1 (1984) (drawing parallel between law and religion in the area of interpretational disputes).

may not be challenged by any shareholder, creditor, officer, or director of the corporation as being unfair to the corporation or a waste of its assets. Most shareholders vote for the amendment. Several shareholders who voted against the amendment sue to have it declared invalid.

Suppose now that the defendant's lawyer introduces an elaborate argument concerning the reasons why rational shareholders might judge it in their interest to give up their right to bring suits based on a manager's breach of the fiduciary duty of loyalty. Derivative actions are disruptive and subject to abuse, market controls over managers' behavior will continue to exist, and so forth. More important, he concludes, there is no good reason for not implementing the voluntary choice made by a majority of the shareholders.[86]

A traditionalist judge might respond to such bold arguments thusly: They sound rational and I cannot decisively rebut all their particular aspects. But they do not feel right and, as I read the case law precedents, fiduciary duties have generally been assumed by prior judges to be nonnegotiable. So I will invalidate such amendments unless and until the legislature authorizes them, or unless and until you revise your arguments so as to convince me beyond a reasonable doubt that your approach is better than the one I read into the traditional sources of corporate law. Our reflections on tradition suggest[87] that such a judge would be acting properly and wisely.

In fairness, and lest it be thought that the essence of my position is a proregulation stance, the same reflections might lead us to approve a judge who rejected a commentator's stringent reform proposal. Suppose, for example, it were urged upon a court that it should flatly prohibit leveraged buyout transactions by corporate managers.[88] The argument would be that some alleged benefits (tax savings) are docu-

86. A minority shareholder might object that he did not consent to the charter amendment, and so should not be bound by it. But he will be met with the counterargument that he consented beforehand to be bound by majority rule, so long as it is expressed by means of the procedures set forth from time to time in the corporate statutes and the case law. After all, he was not forced to buy into a business corporation, and the general invalidity of vested rights arguments against majority rule and even basic legal changes has long been established in the corporate arena. A persistent minority shareholder might observe that he, and probably most other investors, never gave actual, conscious consent to any such arrangement, but assumed that certain fundamental changes were beyond the power of the majority to impose on the minority. As should be obvious, this dialogue implicates yet another set of doubts about the contractual model. At the least, it suggests that the contractualists' rather frequent and important appeals to implicit contracts are very likely to enter contestable territory. Participants in the arrangement may disagree strongly about what the implicit understanding was.

87. A general theory of tradition of the sort sketched in Part V cannot do more than "suggest" the propriety of a particular traditionalist stance. As discussed in Part VII below, there are apparently insuperable obstacles to any attempt to justify a particular form or degree of deference to tradition as optimal.

88. See Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 87 Yale L.J. 1354, 1368-69 (1978).

mented but available in other ways; the other major alleged benefits (improved motivation and monitoring of managers) are speculative and unsupported; and the likely harms to investors (deprivation of the intrinsic value of their shares) are real and serious, as shown by facts turned up in the aftermath of some real cases. A court finding these arguments quite plausible but not utterly conclusive might properly refuse to budge from the traditional[89] approach of not prohibiting conflict-of-interest transactions outright, but subjecting them to some sort of fairness review and procedural restraints.

In other fields of law, one suspects, the proper role of precedent may be somewhat different. The form and degree of respect for traditional principles may be very different in real estate law than in computer law. Consequently, it would be good if there were some clear general guidelines to follow in taking account of tradition. Whether there are is the subject to which we now must turn.

VII. The Unknowable Ideal Balance

The observations in Parts III–V about the relative advantages and disadvantages of using rules generated by contracts, elites, or traditions imply that there are no corner solutions. An ideal normative system will rely on all three sources, though to differing degrees in differing contexts. But the very nature of those observations suggests strongly that it will be impossible in practice[90] for any person or group of persons to specify with any precision what the optimal mix of sources is.

For example, an impossibility theorem is almost inherent in any balanced theory of tradition. The very essence of the argument for following traditional rules is that they are the residue of past decisions by actors in processes that probably led to welfare-enhancing rules, even though the full rationale of the rules is not known to the follower. (If it were, there would be no informational advantage to the tradition, and no utilitarian reason for following it.) This is a global argument. Even if accepted as to a tradition, it does not and cannot show the follower that a particular traditional rule is an optimal or even a good one. Moreover, the other part of the global argument—the powerful reasons for believing that traditions may contain mistakes and have bad side effects—indicates that the risk of suboptimality in particular rules is real. Yet awareness of this problem puts the would-be selective follower of a tradition in a quandary. The only obvious way to identify a

89. Since the early decades of this century, that is. Corporate law presents a relatively hard arena in which to make my points about tradition, since it is a relatively short-lived tradition and has experienced some important shifts in direction.

90. Theory is different. One might devise a precise formal model of the optimal mix, using the economist's technique of considering marginal returns to investments in the use of each of the three sources. But applying such an abstract model to real world situations presents great problems, because it is so hard to get good information about the magnitude of the relevant costs and benefits.

bad traditional rule is to retrieve or discover its rationale and then test it against some competing alternative. Such investigations may be expensive and quite uncertain to produce useful results. There are no clear and specific guidelines telling one when to do such an investigation or what level of resources to devote to it.

Similarly, it is part of the argument for traditional rules that you may think you have discovered a better rule but you may well be wrong, and our general theory about the nature of traditions dictates that you admit this possibility to be a serious one. Yet it also indicates that you may sometimes be right, without giving you any basis for estimating a specific probability of this outcome. Again, there are and probably can be no clear and specific guidelines telling you how much subjective certainty warrants not deferring to the traditional rule. Tradition is valuable precisely because it may be wiser than any particular subject's judgment, whether or not it is experienced as certain.

A similar information asymmetry makes it difficult to draw anything like an optimal line around the power of elites. The basic argument for elite rule making is that the elites may indeed know better; they may possess relevant technical or general knowledge that it would be very costly for each rule subject to acquire and use on her own. Yet particular elitist decisions may be corrupted by imperfect incentives. How is the nonexpert rule subject to judge when this is happening? Some abuses may be obvious, but others may be discovered only by costly second guessing.

The unknowability of the ideal balance may be partly responsible for the extremity of attitudes about the proper sources of law. Those who cannot stand the uncertainty (that is, most of us) may opt for a closed system. To the extent that scholars are driven to such a response, modern contractualism of the sort developed in corporate and commercial law is bound to fare pretty well. It offers a simple, powerful, reasonably coherent, and intuitively appealing framework of evaluation. It works well, even though it is not complete.

Nevertheless, a more inclusive large-scale framework might help protect against the excesses of an exclusionary contractual model. It is worthwhile to try to construct such a framework. Indeed, the seeds of a widely acceptable view about the proper large scale framework may well be present in the implicit values guiding many recent commentators. For the sake of advancing the quest, I offer a restatement of views that seem to be implicit in the better corporate law literature. The restatement is put in the form of a statutory provision, in order to condense the thoughts and facilitate critique. In this respect I follow the ALI in its treatment of many elusive general issues of corporate governance.

1.1. Relations among Sources of Rights and Duties

(a) A traditional rule is a nonstatutory one that has received substantial acknowledgment by courts in this jurisdiction over a significant period of time.

(b) Traditional rules should normally be followed and applied. But a court should choose not to follow a traditional rule to the extent that it conflicts with and is superseded by

(1) a validly enacted and applicable statute; or

(2) a contract between or among the parties to the dispute, when

(A) the contract is determined by the court to be a reasonably explicit and genuine one in all relevant respects, and the traditional rule is determined not to be especially clear, strong, and conflicting, or

(B) the traditional rule is especially clear, strong, and conflicting, but the court is utterly convinced, after a full consideration of a thorough presentation of relevant arguments and evidence, that the contractual arrangement is superior to the traditional rule in promoting the parties' best interests and does not have greater negative side effects on other persons.

(c) A court may choose not to follow a traditional rule to the extent that it conflicts with and is superseded by a new rule that the court wishes to adopt when the court is utterly convinced, after a full consideration of a thorough presentation of relevant arguments and evidence, that the new rule is superior to the traditional rule in promoting the best interests of those governed by the rule and does not have greater negative side effects on other persons.

This approach gives more weight to tradition and the wisdom it may embody than most contractualists seem willing to concede, but it is still a limited and restrained form of traditionalism. Traditional rules may sometimes be trumped by elite rule makers (the legislature or the court) or by contracts. The proposal simply tilts the burden of proof against most proponents of counter-traditional rules,[91] with different standards of proof for different situations.

I do not claim that the approach of the suggested provision is irrefutably correct. One might object that it makes no sense to put the burden of proof on one wishing to change a traditional rule in an area, such as corporate law, where (1) the traditional rules are of fairly recent origin, and therefore have not been subjected to long sifting and shaping by whatever selective mechanisms exist in the tradition-making pro-

91. The proposal does not require the legislature to prove to the court that its reversal by statute of a traditional rule is wise. Legislative processes already impose substantial burdens on those who would change a traditional rule. One hopes, perhaps too optimistically, that these obstacles help screen out welfare-decreasing rule changes. In any event, a similar but hortatory guideline might be drafted for legislators. Legislatures should be wary of imposing new mandatory rules. How wary they should be involves a difficult judgment, but the judgment should be attempted.

cess, and (2) the explicit reasons for most of the traditional rules are relatively easy to retrieve and reevaluate, and (3) there is no apparent reason to suspect that "deeper" but unarticulated reasons either helped generate the rules or now support them. At least the first two items in this objection are matters of degree, however, and I would make the judgment that they do not entail an attitude of no deference toward traditional, judge-made principles of fiduciary duty.

What the objection does suggest is that the degree of deference to tradition should vary across fields of law and bodies of normative custom. For example, one might postulate that a custom or tradition is more likely to have a "deeper" (nonobvious, unarticulated, but real) rationale when it concerns some aspect of human behavior and social relationships that is relatively fundamental and perduring but prone to be the subject of intense and irreconcilable conflicts. Many norms about sex and aggression may fit this description. By contrast, a deeper rationale is unlikely when a rule was clearly invented by a discrete set of individual human beings faced with a statable problem. Rules of work in organizations may be good examples. More generally, less deference is due to what I earlier called "technical" as opposed to "organic" traditions, especially when the history of the tradition is well documented, and it should be possible to develop rough general guidelines for deciding whether a particular body of lore tends more to one or the other side of the spectrum. One such proposed guideline is whether the tradition deals directly with the more basic and perduring features of human relationships.

This last postulate has implications for the understanding of different normative systems. Since religions and informal social groups tend, in their ethical aspect, to focus heavily on basic and perduring features of human relationships, we would expect their sanctioning agents to be invested with a strong bias toward traditional rules. Markets should tend toward the other end of the spectrum. Law should show mixed tendencies. The common-law rules dealing with basic private law topics, as well as constitutional law, deal with relatively basic and enduring issues, and should take on a traditionalist tinge. The distinctive law of the modern regulatory state, dealing as it does with complex and ever shifting institutional arrangements and new social phenomena (e.g., massive pollution, production of electric power, and stock index futures), should display much less deference to tradition. Corporate law falls somewhere between these poles. Corporations are relatively recent and artificial beings, but the main problem that corporate law deals with—the optimal control of discretionary power possessed by those who act on behalf of others—is as old and basic as human nature itself, and certain general principles evolved to cope with that problem, such as the fiduciary duties of care and loyalty, have been a long time in the making.

To summarize and conclude this Part, three points may be noted.

First, the analysis in this Article of different sources of rules has seemed to me to argue for a limited form of traditionalism, which I have tried to formulate, as to judicial decision making, in a proposed restatement provision. Second, even this general statement of limited traditionalism had best be qualified by the notion that in different areas of the law different degrees of deference to traditional rules may be due. I have hinted briefly at the factors that might help decision makers make such distinctions. Third, even if the prior points are rejected, I hope that the reader will take the article to have made a more general point. Law makers, including both courts and legislatures, should be more aware of the systemic risks and benefits of different sources of rules and should include them in their analysis and weighing of factors when considering a given change in the rules. This is a most important lesson.

VIII. Conclusion

Proponents of the contractual model of the firm, as well as other contractualists analyzing legal institutions, tend to ignore or slight the significant role that elites and traditions play in the making of rules. Moreover, in their normative pronouncements, they tend not to acknowledge that noncontractual bases of legal rules could be both legitimate and important. They champion autonomy and abhor heteronomy.

Both of these tendencies are misguided. In the practice of law and in the actual generation of proposals for legal change, the role of elite groups is decisive, even if it is nowadays sometimes constrained by the COPE strategy. Moreover, both judicial and legislative lawmaking activities are intensely traditional in character.

More importantly, it is misguided to deny a significant and important normative role to elite and traditional rule making. As shown in Parts III–V of this Article, each of the three sources of rules has distinctive advantages in certain contexts. In a given context, the information most decisively relevant to choice of a welfare-enhancing rule may be local in character; or it may be of a general nature most economically obtained by those with special expertise or experience; or, in a situation that repeats essential features of situations dealt with by a normative tradition in the past, it may be information already reflected in a received rule or norm. Depending on which condition obtains, the net informational advantage may be possessed by contractual, elite, or traditional rule making. Admittedly, when one considers the quality of the incentives that may lead rule makers to adopt rules enhancing the welfare of rule subjects, contractual rule making will usually dominate traditional rule making, which will often dominate elite rule making. But there is no good reason to suppose that this partial consideration always outweighs the informational advantages that rule making by elites and traditions may possess.

The hardest problem in dealing candidly with the legal system's

use of three sources of rules is deciding upon their proper relationship to one another. For reasons developed in Part VII of this Article, it appears to be impossible in practice to specify an optimal mix. Nevertheless, legal practice requires guidelines of some sort, however rough and general they may be. Accordingly, I offered a model provision, in the style of the ALI's Corporate Governance Project, on the proper treatment of the three sources when they conflict. I also acknowledged that deference to tradition should vary across fields of law, and exhorted law makers to be sensitive to the relative costs and benefits of the different sources of rules.