

# Unconscionability and Consent in Corporate Law (A Comment on Cunningham)

*Kent Greenfield\**

Lawrence Cunningham has written an insightful and persuasive article calling on courts to apply the contract-law doctrine of unconscionability in evaluating executive compensation.<sup>1</sup> According to Cunningham, this additional doctrinal tool will allow courts to engage in genuine and meaningful oversight of excessive compensation. He argues that such oversight is valuable because existing corporate-law doctrine too often prompts courts to defer too much and too often to management's decisions.

Cunningham's argument is modest yet impactful. It is modest in that it simply proposes that courts take account of a well-established area of contract law to analyze and evaluate the compensation contracts of corporate executives. It is impactful in that, as he points out, courts applying the doctrine of unconscionability will find that sometimes, some compensation contracts will be set aside. Perhaps courts will only find the worst of these contracts unconscionable. But that is more than zero, the number we can expect courts will find offensive to corporate-law norms as presently understood and adjudicated.

This Essay will put Cunningham's argument in the context of the larger debate over the dominant metaphors of corporate law. One way to tell the intellectual history of corporate law is to describe a battle between those who believe the dominant metaphor for the field is contract and those who believe it is property.<sup>2</sup> In the contract metaphor, duties derive from voluntary agreements between and among parties to a deal. In the property metaphor, duties flow from status or rights, despite the absence of agreements or the existence of agreements to the contrary. One might think that Cunningham's article fits squarely within the contract metaphor—he is, after all, calling on courts to use contract-law doctrine to evaluate corporate-law questions. In my view, however, Cunningham's argument fits within the

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\* Professor of Law and Law Fund Research Scholar, Boston College Law School.

1. Lawrence A. Cunningham, *A New Legal Theory To Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177 (2011).

2. See David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201 (1990).

larger movement away from the simplistic contractarian norms that have dominated the corporate-law field for the last generation. Cunningham's argument in favor of contract doctrine is, in fact, best viewed as a celebration of property-law principles. Ironically, Cunningham's article, arguing for an analysis based in contract law, is yet another attack on the dominance of contract reasoning in the theory and doctrine of corporate law.

1.

Early in the history of corporate law, both property and contract notions were prominent in theory and doctrine. In the famous 1819 *Trustees of Dartmouth College v. Woodward* case, Chief Justice Marshall said that corporations were state creations with such purposes "as the government wishes to promote."<sup>3</sup> According to the Court, the corporation was a "trustee" of those who contributed to it, a duty-based and status-based conception. This articulation sits best within a property metaphor, as the obligations of management, and indeed the corporation itself, came as a result of a bestowal of property rights, which carried with them obligations to the general public and to those who contributed to the entity. But Chief Justice Marshall also articulated a contract metaphor for the corporation, explaining that the understandings between the state and the college "constitute[d] a contract."<sup>4</sup> Indeed, the ultimate holding of the case—that the state of New Hampshire could not unilaterally amend the corporate charter—flows directly from contractual reasoning.

In corporate law's middle history, the property metaphor was ascendant. Berle and Means described the separation between ownership (shareholders) and control (management).<sup>5</sup> Theorists and courts responded by developing the obligations managers should owe to the owners, whose property they controlled. In this period, the best source of the law of managerial obligation was derived from the law of trusts—the law of how one is entrusted with another's property. Also during this period, courts took what appears to modern sensibilities as a hard look at managerial behavior because they viewed management as owing real duties to the firm. Courts even used the duty-encrusted rhetoric of property law to hold corporate executives to "something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive."<sup>6</sup>

Over the last generation or so, the idea of corporation as contract has gained the upper hand. Now, the corporation is seen as a nexus of contracts

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3. *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518, 637 (1819).

4. *Id.* at 627.

5. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

6. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

among a host of different contributors, and shareholders are not seen as owners but simply contributors of capital. Managerial obligations are derived from explicit, implicit, or default contractual terms between management and shareholders. Within the contractarian view of the field, law should not dictate the details of the obligations among a corporate contract's parties because each party is assumed to know its own interests and to protect them through bargaining and exchange. In this way, the argument goes, developments in corporate charters and, indeed, in corporate law will trend toward efficiency because inefficient arrangements will cause participants in those arrangements to change the terms of the bargain over time in order to avoid losses.

One of the main implications of the triumph of the contractarian theory is the massive deference courts now show to the decisions of corporate executives. The theory maintains that courts should not question corporate decisions because the market itself will correct any mistakes. The arrangements among the various parties are voluntary, so law does not need to step in to vary the terms of the deal.

Perhaps the best statement of this assumption appears in Judge Winter's famous opinion for the Second Circuit in *Joy v. North*, one of the earliest case-law articulations of the contractarian model.<sup>7</sup> Explaining why shareholders should not be able to win a fiduciary-duty suit brought against negligent directors, Judge Winter posited that shareholders had chosen to take the risk of directors' negligent behavior: "[S]hareholders to a very real degree voluntarily undertake the risk of bad business judgment."<sup>8</sup> How had they expressed their choice? By buying the stock. As Judge Winter stated:

Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers. Nor need investors buy stock in particular corporations. In the exercise of what is genuinely a free choice, the quality of a firm's management is often decisive and information is available from professional advisors. Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.<sup>9</sup>

This view of contract is aggressive. The shareholders had not entered into an agreement waiving their right to sue the directors for a fiduciary-duty breach. But in Judge Winter's view, investors entered into a contract because they acted in a way that brought about consequences they could have anticipated. In other words, because people know that some managers make

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7. *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

8. *Id.* at 887.

9. *Id.* at 885.

mistakes and because people are rational actors, we can assume people accept the risk of managerial mistakes when they purchase stock in a company. Thus, shareholders would receive a windfall if they were allowed to recover for those mistakes.

The problems with this line of argument are many. The core problem is that this argument depends on a highly simplistic and problematic view of human rationality and voluntariness. In this line of thinking, we know what people want because their actions reflect what they want. This view of rationality is so thin that, in the words of Judge Posner, “[I]t would not be a solecism to speak of a rational frog.”<sup>10</sup> In a way, the thinness of rationality is its power—we do not need to probe beyond the straightforward query of whether the corporation coerced an individual into behaving a certain way or fraudulently tricked the individual into behaving a certain way. If not, then courts should let things lie.

Given this thin view of rationality and voluntariness, the fact that shareholders invested in the firm is evidence that they assumed the risk of whatever managerial malfeasance occurs. If they think malfeasance likely, then they should either not invest or ask for protections. If they do not protect themselves in such ways, they should not expect courts to rescue them after something goes wrong.

As Cunningham explains, this is the state of things when it comes to challenges to excessive executive compensation. No matter how seemingly disproportionate the compensation is to the performance of the executive, courts will not intervene. Courts apply the deferential business-judgment rule, which means, in effect, that management wins. The implicit, contractual thinking is that shareholders should protect themselves; if they do not, then the fact that they have not is evidence that they have consented to the arrangement.

## 2.

While courts—particularly Delaware courts—have continued to implicitly adhere to contract theory by deferring almost completely to management in corporate-law cases,<sup>11</sup> contractarianism has come under increasing attack by the academy. Behavioral economists’ insights have cast serious doubt on the rational-actor model underlying the theory, and a multitude of writers have pointed to several flaws in the simple versions of voluntariness and consent that form the basis of contractarian deference to agreements.<sup>12</sup>

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10. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 15 (3d ed. 1986).

11. See Kent Greenfield, *Law, Politics, and the Erosion of Legitimacy in the Delaware Courts*, 55 N.Y.L. SCH. L. REV. 481, 495 (2010).

12. For the beginnings of a scholarship review, see Kent Greenfield, *Using Behavioral Economics To Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS L. REV. 581 (2002).

Cunningham recognizes these behavioral-economics insights. He says, for example, that “[t]he optimal-contracting model and agency–principal accounts work wonderfully in theory, but corporate governance realities make them often inaccurate descriptions of the actual state of affairs. Managerial power can be too great in some modern U.S. corporations to rely on the model’s envisioned contracting exercises.”<sup>13</sup> In other words, contracts are not always trustworthy.

They cannot be trusted, in part, because human choices are malleable and easily manipulated. Preferences can be created and destroyed. The more we understand about the way humans actually make decisions, the more we understand that humans do not easily fit within the neoclassical view of rational actors. Any sophisticated account of “voluntariness,” “consent,” or “choice” has to come to terms with bounded rationality and bounded will power, and contain a richer definition of self-interest.<sup>14</sup>

Here is the real issue. As a matter of theory, contractarianism makes sense only when we assume humans are different from, and simpler than, we really are. We can go ahead and assume voluntariness when it does not exist; we can assume people agree when they do not; we can assume people maximize their own welfare when they do not. But if we create legal doctrines based on these assumptions, we need to acknowledge that we are basing our governing rules not on reality but on constructs. And we use these constructs not because they do a good job of predicting behavior but because they make it easier for the law to derive an answer in a legal dispute, even if they do not actually represent human behavior at any level of nuance.

I find it interesting that the law lags behind other areas of academic research in understanding human behavior. Social science is increasingly sophisticated in its understanding of human cognition, behavior, and choice. One can hardly open up a mainstream news periodical without reading about a social-science experiment about how humans act predictably but “irrationally” from an economic perspective. Popular books such as *Predictably Irrational*,<sup>15</sup> *Nudge*,<sup>16</sup> *Stumbling on Happiness*,<sup>17</sup> and *Blink*<sup>18</sup> translate these findings for the general reading public.<sup>19</sup> Some cutting-edge legal scholars are beginning to explore the implications for law, but their insights are not yet widely adopted by courts.

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13. Cunningham, *supra* note 2, at 1190–91.

14. See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1476–93 (1998).

15. DANIEL ARIELY, *PREDICTABLY IRRATIONAL* (2008).

16. RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE* (2008).

17. DANIEL GILBERT, *STUMBLING ON HAPPINESS* (2007).

18. MALCOLM GLADWELL, *BLINK* (2005).

19. With hope, I might add KENT GREENFIELD, *THE MYTH OF CHOICE: PERSONAL RESPONSIBILITY IN A WORLD OF LIMITS* (forthcoming 2011).

Having said that, there is one area of law that seems receptive to the behavioralists' insights. Ironically, that area is contracts. For centuries, contract law has struggled with the question of when otherwise valid contracts should be set aside because of unfairness in the bargain, mistake, duress, bad faith, undue influence, or unconscionability. In a sense, each of these doctrines allows courts to oversee the substance of deals and set aside those contracts that do not seem to fit with a genuine sense of voluntariness or choice. As Cunningham says, unconscionability "signals absence of mutual assent" and allows courts to set aside particularly "obnoxious arrangements."<sup>20</sup> The same can be said about the other doctrines listed above. All in all, the main purpose of these doctrines is to allow courts to mitigate the harshness of contract law in the most egregious cases of unfairness.

Over the centuries, the availability of these doctrines has waxed and waned, mostly as a function of whether the legal zeitgeist was one of respect for parties' autonomy (in a libertarian sense) or one more understanding of the vagaries of human behavior and consent. But even in eras in which the "freedom" of contract was most revered, contract law included these mitigating doctrines as possible tools of analysis for courts. In a sense, then, contract law has long understood that a robotic application of simplistic notions of voluntariness can result in outcomes that do not map well to strong public policy or a sophisticated understanding of genuine human agency.

Another way to describe these contract-limiting doctrines is to say that they import property-based limitations into contract law. The availability of these doctrines allows courts to say: "We understand that the agreement might be considered valid if we considered only superficial notions of voluntariness, but we also understand that human decision making has limits and flaws. This agreement offends one of the parties' right to be treated with a basic level of dignity and fairness. We therefore set it aside and refuse to enforce it."

Perhaps oddly, whether we want courts to say this depends less on the substance of the statement than on what we think of courts. The attraction of courts using the neoclassical-economics view of human rationality is that it is clear. It allows courts to make judgments based on straightforward assumptions about human behavior. Although it is clear, the shortcoming of the neoclassical school of human rationality is that as we are learning more and more, humans do not act in economically rational ways much of the time. Humans are messy; we act out of love, altruism, spite, stupidity, loyalty, and other irrational motivations.

Contrastingly, the shortcoming of a more robust view of human agency is that it is not clear. Courts and other decision makers will be unsure how to

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20. Cunningham, *supra* note 2, at 1214-15.

draw the line between choices that should be respected and those that should not. The advantage of a more robust view of human agency is that it is more accurate. We lose clarity but gain a more nuanced sense of the way humans actually behave.

If we think courts should, above all, create clear rules that people can plan around, then we should adopt the neoclassical account of human agency and the benefit of its clear rules. If, on the other hand, we think courts should seek to make judgments based on the contexts and equities of each case, then we should provide them with doctrines to allow flexibility. The costs of such flexibility are real, but they may be outweighed by the benefits of empowering courts to seek equity in complicated, messy, human situations.

3.

Now back to corporate law.

I applaud Cunningham's proposal to import contractual unconscionability into corporate law. I applaud it because it moves us away from contractarianism and toward a more robust and sophisticated understanding of how the world—even the business world—actually works.

I also applaud it because it helps make clear that the dominant “nexus of contracts” theory of corporate law is based less on contract *doctrine* than on relatively simplistic contract *theory*. The theory takes as its guide a *laissez-faire*, *Lochner*-era view of contractual freedom that has little purchase outside of corporate law. In contract law itself, as Cunningham makes clear, the neoclassical-economic view of human rationality is mitigated by a number of available doctrines, such as unconscionability. Cunningham's argument that courts should use unconscionability to evaluate executive pay is therefore perfectly designed to highlight this insight. It turns out that it is not contract law the contractarian corporate-law scholars want to mimic, but libertarianism.

Why is that so bad? If we think that law should do something other than empower the most powerful people among us to become even more powerful, then it is bad. Libertarianism, at its base, simply asks that government stay out of all private exchanges, other than when government is needed to enforce them. But if we believe that certain rights should be “taken for granted” and not subjected to bargaining, then we need to balance our respect for voluntary exchanges with legal doctrines and principles that open our eyes to issues of genuine human agency, human dignity, and fairness.<sup>21</sup>

This may seem far afield from traditional corporate-law analysis, and perhaps it is. But it need not be. It might be possible for courts—yes, even

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21. Joseph W. Singer, *Things that We Would Like To Take for Granted: Minimum Standards for the Legal Framework of a Free and Democratic Society*, 2 HARV. L. & POL'Y REV. 139 (2008).

courts in Delaware—to do something other than merely validate whatever management has decided. It might be possible for courts to take a genuine hard look at executive pay, even when compensation derives from a putative agreement between corporate executives and the corporations they run. It might be possible to ask courts to take responsibility for truly judging the equities of a certain deal, rather than hiding behind beliefs of contractarian infallibility that contract law itself does not accept. It might be possible to have corporate-law doctrine contain within it some kind of fiduciary duty in fact rather than just in name. And that would be progress.