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The Nature of Conflicts of Interest Within the Firm

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The Nature of Conflicts of Interest Within the Firm

Jonathan Macey*

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I. INTRODUCTION

There are many ways to evaluate the quality of a jurisdiction’s business law rules. From a practical point of view, however, there is no better method of evaluating the efficacy of a particular system of rules than by measuring how conflicts of interest are handled.

Conflicts of interest are ubiquitous and inevitable. From decisions about executive compensation to decisions about corporate control transactions, corporate governance systems regulate conflict within the firm. In fact, viewed broadly, a strong argument can be made that corporate law does very little of much value other than regulating conflicts within the firm. Indeed, moving beyond the confines of corporate law to the issue of conflicts of interest more broadly, traditional ethical theory presumes that conflicts of interest are fundamental to the human condition and that the study of ethics contains the solutions to these dilemmas. Put simply, ethical norms are what inform the decisions about whose interests should be sacrificed in order to resolve the conflicts.

Conflicts of interest are a perennial problem precisely because they cannot be prohibited.1 They must be regulated, simply because often it is simply not possible, much less desirable, to avoid conflicts within the firm. Executives have to be paid. Firms need

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1. Conflicts of interest implicate the fiduciary duty of loyalty that officers and directors owe to shareholders and corporations. The duty of loyalty claim is implicated “when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all shareholders.” In re Walt Disney Derivative Litig., Civ. A. No. 15452, 2005 Del. Ch. LEXIS 113, at *164 (Del. Ch. Aug. 9, 2005).
capital, and sometimes, particularly when the firm is in distress, that capital can come only from insiders. More generally, firms must make decisions in the ordinary course of business, and these decisions inevitably generate conflict. While these conflicts may or may not rise to the level of legally cognizable conflicts, they are conflicts nonetheless. Decisions to raise prices, raise workers’ wages, change suppliers, relocate, or pay dividends instead of reinvesting the free cash flow, all make some of the corporation’s constituents better off while making other constituents worse off. In this and many other ways, they create conflicts within the firm. Thus, ethical theory only guides us to the extent that we can avoid conflicts, which is to say, hardly ever as a practical matter. Some way of managing conflicts is necessary in the real world, and that is through the contracting process.

For this reason, theories that suggest that the way to deal with conflicts of interest is simply to avoid them are not of much practical value, since in the real world it simply is not possible to avoid conflicts entirely. An additional practical problem associated with the standard ethical perspective on conflicts is that it fails to distinguish between what economists would characterize as ex ante conflicts and what they would describe as ex post conflicts. An ex ante conflict is one that emerges, or can be reasonably foreseen, before a party has made any sort of investment or commitment in a particular endeavor. An ex post conflict is one that emerges after investments or commitments have been made, and could not reasonably have been foreseen by the parties prior to making their investments.

Conflicts that were anticipated ex ante, or that should have been anticipated ex ante, should be treated differently than conflicts that are unforeseeable. Putting together these two categories, there is one large set of conflicts that are unavoidable but foreseeable, and a smaller set of conflicts that are both unavoidable and unforeseeable. It is the latter, smaller set of conflicts that we need worry about, because this is the set of conflicts that cannot be solved adequately through either explicit or default contractual arrangements.

A puzzle emerges from the above analysis. Many of the conflicts that appear to undermine modern corporate governance are quite foreseeable. In particular, conflicts such as executive compensation and the proper role of management in dealing with mergers and acquisitions are ubiquitous, widely discussed in the literature, and easily dealt with, at least in theory if not not in practice. The puzzle here is why more is not done to deal with these problems through ex ante contracting. The answer appears to be simple, although perhaps unsatisfactory to some. These types of conflict problems are highly complex and highly contextual. These two characteristics, complexity and context, indicate that solutions are not only difficult, but likely to vary in substance from firm to firm.

The thesis of this Article is that the very notion of conflicts of interest within the firm has been too narrowly conceived and that the narrowness of current conceptions of the nature and meaning of conflicts has led to the production of bad law and policy in this area. In particular, I am of the view that the law’s presumption that a sharp distinction exists between the duty of loyalty and the duty of care in corporate law is overstated.

Part I of this Article describes the nature of the conflicts of interest that exist within a firm from an economic perspective. In this section of the Article, I argue in favor of a broader understanding of the concept of conflicts of interest within the firm. Part II of the Article explores how this broader understanding of conflicts might affect our approach to legal problems in this area. In particular, some problems such as loans by corporate direc-
tors and officers to their firms should be evaluated under a more relaxed standard than is
done at present. On the other hand, other conflict issues, such as executive compensation
and the conduct of directors during mergers and acquisitions, should be evaluated under
more intrusive legal standards than at present.

II. UNDERSTANDING CONFLICTS WITHIN THE FIRM

The starting place for understanding the conflicts that exist within the corporate en-
terprise is Ronald Coase's classic work *The Problem of Social Cost.* The Coase Theo-
rem posits that under conditions of zero transaction costs and well-specified property
rights, market participants will organize their activities in ways that inevitably will
achieve efficient outcomes. As market participants include investors, this theorem also
implies that investors would organize their strategic investment choices to achieve effi-
cient outcomes.

A. Coase and Corporate Governance

One implication of the Coase Theorem is that government intervention is not neces-
sary and likely will be harmful. The rationale is that, intervention is most likely to occur
in situations in which the participants in the corporate enterprise—i.e. shareholders, lend-
ers, managers, workers, etc. —are able to work out their problems for themselves. The
biases, small stakes, and susceptibility to capture that characterize the interests of bureau-
crats further diminish the likelihood that regulatory intervention will be of value in
achieving the social welfare goal of maximizing the overall value of the firm.

Conflict of interest transactions occur under conditions that in many ways resemble
a perfect, Coasean world of zero transactions costs. The parties not only know each other,
but engage in repeated contractual dealings. In addition, the parties have lots of informa-
tion regarding the issues about which they are contracting and a significant amount of ex-
perience and expertise which enables them to evaluate this information.

The following example illustrates the point being made here about the role of the
Coase theorem in modern corporate governance. To motivate the analysis that follows,
imagine a simple model illustrated by Table 1 below. In this model, the board of directors
of a company is required to select a strategic investment for their firm among three in-
vestments. In selecting among these three strategies, the firm's board of directors must, at
the outset, elect whether it wants to become "Firm A," "Firm B," or "Firm C," each of
whose business prospects are reflected in the panels contained in Table 1.

The firm's directors will be making their strategic choice about what sort of business
to pursue with certain known information. First, they know that the firm has assets with a
current present market value of $1000 and liabilities with a current present value of

5. For the use of the analytical methodology being employed here in a different context, see Jonathan
Macey & Geoffrey Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of
$500. Also, for the sake of simplicity, the model assumes that the company's business both begins and ends during a single period. At the end of the period the assets of the firm are sold and the proceeds distributed among the claimants to the firm's cash flows (shareholders and lenders) in the usual order of priority.

As explained more fully below, the firm's directors must decide to allocate the firm's resources among one of the following three alternative businesses. The choice made will both affect the firm's constituencies and have different implications for overall social welfare. Specifically, Firm A represents the investment strategy that, from the ex ante perspective of the participants, maximizes the overall value of the firm, and hence societal wealth. Firm B represents the safest deployment of investors' assets, and hence the deployment preferred by the firm's fixed claimants, such as banks and other lenders, bondholders, and perhaps workers. Firm C depicts the allocation of assets that shareholders, particularly fully diversified shareholders, would prefer, since this is the outcome that maximizes the value of the common stock.

6. In this schema, I assume that the $500 represents the principal and interest due on money borrowed from fixed claimants—securities holders or banks—whom, for ease of exposition, I refer to here simply as "banks."

7. To keep the model simple, I am assuming that the company's business does not generate negative externalities, like pollution, that would cause the expected value of the firm to deviate from the net societal value of the firm's activities—though it would not be difficult to layer in such an assumption. This could be done simply by assuming that the expected value of the firm reflects both the net cash flows to contracting constituencies such as shareholders and fixed claimants, as well as non-contractual constituents, like local communities, and even the environment.

8. Again, the model assumes only one class of residual claimants. These are the common shareholders.
The Nature of Conflicts of Interest

Table 1

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In order to depict the inevitable uncertainty that is associated with the choices available to the company’s board of directors, the first column shows a range of possible outcomes for each of the three choices facing the directors, along with the probability that I assign to each of these possible outcomes. The second column, marked “Firm,” depicts the financial return to the business as a whole associated with each of the probabilities in the first column.

The third column, marked “Bank,” shows the monetary return available to fixed claimants under the various probabilistic scenarios described. Because fixed claimants (such as banks) enjoy a higher priority in cases of insolvency than residual claimants (such as shareholders), they benefit in certain situations where shareholders do not. For example, if the board chooses to become Firm A in the above example and it turns out that the firm ends up at the end of the investment period to be worth only $400, then this entire amount will be paid to the fixed claimants. Under this scenario, of course, there will be nothing left over for the common stockholders. This is reflected in the heading entitled “Common” in the fourth column.

We can calculate the ex ante expected return of this investment by multiplying each possible monetary return by its associated probability. Thus, for the firm as a whole, the 50% probability (depicted as .50 in the “Probability” column) that the firm will be worth

9. Note that there is a 10% chance of this happening.
$2000 at the end of the investment period translates into an "Expected Value" for the firm of $1000 (0.5 \times 2000 = 1000). This, in turn, represents a 50% chance that the firm’s fixed claimants will receive $500 and a 50% chance that the firm’s shareholders will receive $1500 (because if the firm is worth $2000 at the end of the investment period, the common shareholders will receive $1500 of this, which is, of course, the residual that remains after the firm’s fixed claimants have been repaid the $500 that is owing to them).

As Geoff Miller and I have noted in a previous article, different constituencies of the firm, from workers, banks, and other fixed claimants on the one hand to shareholders on the other hand, will have different views about which of these investments to pursue. In a perfect Coasean world, however, the board of directors of the firm will elect to organize the firm with the risk-return characteristics of Firm A in the above example. This is because with Coasean bargaining, "the parties can improve on any equilibrium that does not maximize the overall value of the firm." 10

Suppose, for example, that the shareholders dominate the board of directors and, after looking at the available strategic alternatives, propose that the company organize itself as Firm C, in order to maximize the expected value of the firm for shareholders. Changing their plans to organize the business as Firm A, the socially optimal outcome, rather than as Firm C, the outcome that is in the narrow interests of the shareholders, would decrease the value of the shareholders’ investment by $125, from $1650 to $1525. But the same move, from Firm C to Firm A, would increase the value of the fixed claims from $350 to $495, for a total gain of $145.

The fact that the creditors gain by a move to Firm A from Firm C by more than the shareholders lose from the move means that there are gains to be made from rational bargaining between Firm A and Firm C about how the firm should deploy its resources. Specifically, the creditors could offer to pay the common shareholders to induce them to abandon their plans to organize as Firm C and to pursue Firm A. The bargaining space is $20. In other words, both shareholders and creditors will be better off if the directors elect to organize as Firm A, and the creditors pay the shareholders some amount greater than the $125 that the shareholders lose from the move, and less than the total gain of $145 that creditors will experience when the move is made. For example, a move to Firm A coupled with a payment of $135 by the creditors to the shareholders will result in an investment that makes both the creditors and the shareholders better off by $10. 11

A similar Coasean result occurs if, as may be the case, directors representing fixed claimants come to dominate a company’s corporate governance decision-making process.

10. Macey & Miller, supra note 5, at 80.
11. The payment from creditors to shareholders of $135 improves the creditors’ position by $10, because the move to Firm A provides them with an increase in wealth of $145, while the payment to the shareholders decreases their wealth by $135, resulting in wealth of $360 ($495 in returns from the investment in Firm A, minus the $135 resulting in a net increase in their wealth of $360, which, in turn, is an increase of $10, over the $350 expected value of the fixed claimant’s proposed investment in Firm C). The payment from the creditors to the shareholders of $135 improves the shareholders’ position by $10 as well. The move to Firm A decreases the expected value of their equity investment by $125 (from $1650 to $1525), but the $135 payment from the creditors erases this loss and adds $10 to the plus column. The $20 in total gains to shareholders and creditors from moving from Firm C to Firm A represents a distribution of the surplus value that comes from moving from a lower value deployment of resources to a higher value deployment of resources. Firm C is a lower value deployment of resources because the expected value of Firm C is only $2000 compared with an expected value for A of $2020.
In such a situation, the starting position from a bargaining perspective would be a decision to allocate the company's resources in a configuration resembling Firm B. If this were the starting point, then the firm's shareholders, if acting rationally, would approach the creditors' representatives on the board and offer them a payment of some amount greater than $5 and less than $150 in exchange for their agreement to acquiesce in a redeployment of the company's assets towards a configuration resembling Firm A.

Suppose that the shareholders offered to split with the creditors the gains from trade associated with a move to Firm A. This would translate into a payment from the shareholders to the creditors of $72.50, which, in turn, would make the shareholders better off by $77.50, and the creditors better off by $67.50.\textsuperscript{12}

B. Practical Examples of the Conflicts

It is useful to illustrate the conflicts among the various classes of claimants to a firm's cash flows described in theoretical terms above with some concrete examples. At the outset, however, three clarifying points are required. First, while the model set forth above uses only two classes of claimants, common shareholders and banks, in reality there are, of course, many different kinds of equity claimants as well as many different kinds of fixed claimants. There also are various classes of claimants on the cash flows of the firm that are difficult to categorize. This is particularly true for managers and workers, whose claims are hybrid in nature because they possess some of the characteristics of debt and some of the characteristics of equity. The salaries received by managers and workers are identical to fixed claims. However, to the extent that workers and managers receive bonuses, stock options, greater job security, raises, better pensions and health care plans, better opportunities for promotion, and other tangible economic benefits when their employers do well, these corporate constituents cannot accurately be characterized as purely fixed claimants.

Regardless of the complexity of the contractual arrangements that characterize the people and firms that have contractual relations with a company, the same basic point remains: conflicts among these various classes of claimants about strategy and tactics are ubiquitous. Contracts are necessary to address these conflicts.

Second, the bargaining that takes place among the various classes of contractual claimants is not always observable. Such "virtual bargaining" takes place across markets and assumes many forms, including contract design, securities design, and price adjustments. Such bargaining does not always involve the two-step process described above of starting from a fixed, inferior position (i.e., the initial positions of Firm B and Firm C) and moving to another position that maximizes the overall value of the firm. Often a single, integrated process, such as the process of going public or of raising funds from outside investors to start or to recapitalize a firm, generates the optimal result.

Finally, the contracting risks associated with investing can be subdivided into two distinct analytic categories: adverse selection risk and moral hazard. Adverse selection

\textsuperscript{12} This deal would make the shareholders better off by $77.50, because the shareholders would gain $150.00 from the move from Firm B to Firm A, which would be reduced to $77.50 by the $72.50 payment to the creditors. The creditors would be better off by $67.50, because the $72.50 they receive by way of side payment from the shareholders would be reduced to $67.50 by the $5 reduction in expected value associated with the switch from doing business with a firm resembling Firm B to doing business with a firm resembling Firm A.
risk is the risk that results from the fact that creditors value Firm B more highly than they value Firm A or Firm C, and shareholders value Firm C more highly than they value Firm A or Firm B. Consequently, when founding entrepreneurs are seeking to raise money from shareholders, they have incentives to mischaracterize the investments being sold as resembling investments in Firm C, even when the firm is more likely to pursue investment strategies resembling Firm A or Firm B. By making such a mischaracterization, entrepreneurs can obtain funding from equity claimants at lower cost than they would be able to if they represented the characteristics of the investment with complete accuracy. Thus, investors and others thinking about dealing with a firm face an adverse selection problem because asymmetries of information make it difficult for them to evaluate fully the risks associated with their investments. Firms have an incentive to try to make themselves look less risky (i.e., more like Firm B) to lenders, and more potentially profitable (i.e., more like Firm C) to equity investors. The problem that investors face in distinguishing among various firms in the face of information asymmetries between themselves and such firms is known as the adverse selection problem.  

While adverse selection problems exist before an investment is made, moral hazard problems emerge later, after investors have committed resources to a project. Moral hazard refers to the risk that once a firm has obtained investors’ resources, they have strong incentives to alter their investment plans in order to transfer wealth from the investors to themselves. Thus, if an investment is made in Firm C, and later the creditors succeed in gaining control of the firm, they will have strong incentives to alter the firm’s investment strategy such that it assumes the risk profile of Firm B. Similarly, if an investment is made in Firm B, and later the shareholders come to dominate the board, they have incentives to redeploy assets in such a way that the firm comes to resemble Firm C. Of course, both equity claimants and fixed claimants face moral hazard as investors in Firm A. Shareholders will nudge the firm in the direction of Firm C, and creditors will nudge the firm in the direction of Firm B.  

These moral hazard problems all represent conflicts of interest that exist among the various claimants to the cash flows of the firm. Unfortunately, it is very difficult to distinguish ordinary business operations from examples of moral hazard. The board of directors of a firm that resembles Firm C, for example, could be engaging in moral hazard, transferring wealth from fixed claimants to shareholders. Alternatively, if the creditors of Firm C were fully apprised of the company’s investment plans before they made their investments, then presumably they also were compensated for the risks associated with their investments. It would not be possible under these circumstances to argue that the creditors are being harmed or exploited by the board’s pursuit of deployments of assets in strategies that cause the firm to resemble Firm C.  

From a policy perspective, the only way to evaluate the conduct of the firms in the scenario above is with reference to disclosures. As long as firms disclose to investors the nature of their business and the risks associated with their endeavors, then investors should not be permitted to complain later on about the risks associated with the firm’s activities. If investors are told of the risks associated with an investment and invest

14. It is also accurate to describe the moral hazard as one that exists between the various claimants to the cash flows of the firm and the firm itself.
anyway, presumably after being compensated for those risks, from an ex ante perspective, any recovery for bad outcomes later on constitutes a windfall for such investors.

I. Blackmore Partners v. Link Energy

The theoretical points made here are amply illustrated by the recent decision of the Delaware Chancery Court in Blackmore Partners v. Link Energy.\textsuperscript{15} This case sharply illustrates the elemental nature of the conflict between the interests of the various claimants to the cash flows of the corporate enterprise. Link provides a useful illustration of the points made here about conflicts of interest within the firm. In Link, equity holders whose interests were trading in the capital market for $5.00 per share, saw their financial claims completely eviscerated as the company’s board of directors agreed to a sale of 100% of the company’s assets for a price sufficient to provide compensation for all of the firm’s fixed claimants. However, the sale was not sufficient to provide any compensation whatsoever for equity holders.

Link Energy emerged from the October 2002 bankruptcy reorganization of a company called EOTT Energy Partners, L.P. The plan of reorganization created a new company, called Link Energy LLC, which emerged from EOTT’s bankruptcy on March 1, 2003 as the successor entity.\textsuperscript{16} Link’s business plan was “to engage in the same business as its predecessor entity, namely purchasing, gathering, storing, transporting, processing and reselling crude oil, refined petroleum products, natural gas liquids, and other related products.”\textsuperscript{17} EOTT’s plan of reorganization called for Link to issue “$104 million in senior unsecured 9% notes [hereinafter Notes] to replace $235 million of 11% senior notes” held by various groups of EOTT creditors.\textsuperscript{18} Even with this recapitalization, “Link remained [relatively] highly leveraged.”\textsuperscript{19} These creditors also received 95% of the new equity issued by Link.\textsuperscript{20}

Three percent of the new equity issued by Link was distributed in the bankruptcy to holders of EOTT’s equity holders, “one of whom” brought suit against Link.\textsuperscript{21} Critically, the contractual provisions related to the Notes contained a provision obligating “any purchaser of substantially all of Link’s assets to assume” responsibility for paying the principal and interest due on the Notes.\textsuperscript{22}

The charter under which Link operated authorized the Link board of directors to sell “all or substantially all of Link’s assets without a vote of the [equity] holders.”\textsuperscript{23} All seven of Link’s board members, including Link’s CEO, Thomas Matthews, were approved in the bankruptcy proceeding by EOTT’s former note holders.\textsuperscript{24} The success of

\textsuperscript{15.} Blackmore Partners, L.P. v. Link Energy LLC, Civ. A. No. 454-N, 2005 Del. Ch. LEXIS 155 (Del. Ch. Oct. 14, 2005) (describing the types of conflicts of interest that can arise within a firm over the cash flow of the corporate enterprise).
\textsuperscript{16.} Id. at *2.
\textsuperscript{17.} Id.
\textsuperscript{18.} Id. at *3.
\textsuperscript{19.} Id.
\textsuperscript{20.} Link, 2005 Del. Ch. LEXIS 155, at *3.
\textsuperscript{21.} Id.
\textsuperscript{22.} Id. at *4.
\textsuperscript{23.} Id.
\textsuperscript{24.} Id.
the business plan developed by Link's management depended on the firm's ability to attract $100 million of new equity into the company, "to lower Link's debt levels and reduce its cost of credit." This plan proved unsuccessful despite repeated attempts.

Unable to attract outside equity, "Link attempted to improve its financial" condition by "selling some non-strategic assets." Nevertheless, the company continued to sustain losses. Apparently as a last resort, "Link consider[ed] an acquisition offer by Plains All American Pipeline, L.P." to purchase "substantially all of the company's assets." "The Link board of directors formed a Special Committee" to consider Plains' offer. "Plains initially" expressed interest in "assum[ing] the Notes as required by the bonds' restrictive covenant." "Plains ultimately" decided "it would only assume the Notes upon a substantial, and probably prohibitive, discount to the purchase price for Link's assets."

Link management, unable to persuade the purchaser to assume the Notes, began to investigate whether and on what terms the Note holders would be willing to waive their contractual veto rights over potential transactions. After strenuous negotiations, Plains agreed to pay $290 million for Link's assets, and Link's Note holders agreed to waive the restrictive covenants in their Notes in return for a commitment by Link to repay the principal and accrued interest on the Notes and to pay the Note holders their proportionate share of up to $25 million from any funds remaining after the company wound up its affairs, but before any distribution to equity holders. The Special Committee of Link's board of directors met on March 30, 2004 to consider the asset sale. The Special Committee recommended the sale on March 30, 2004 and the deal closed two days later.

In Link, the court noted that "[t]he factual question of whether Link was insolvent or in the zone of insolvency during the contested period is an important one for the court's final disposition in this case, as it controls whether the board of directors owed fiduciary duties to the Note holders." An expert witness for the defendants determined that the company's equity had no value, and that Link suffered from strained liquidity, negative cash flow, and operating losses.

The plaintiff argued that because the asset sale deprived the equity holders of consideration that would have gone to them but for the actions of the board in agreeing to the demands of the Note holders, the actions of the board should be subject to enhanced scrutiny. In ruling for the defendants, the court observed that Delaware's business judgment rule operates primarily as a presumption that directors making business decisions act in

26. Id.
27. Id. at *6.
28. Id.
29. Id. at *7. The court observed that Link's board was acting in desperation.
31. Id.
32. Id.
33. Id.
34. Id. at *8.
36. Id. at *10.
37. Id.
38. Id. at *12.
39. Id. at *13.
good faith, on an informed basis, and in the honest belief that their actions are in the corporation’s best interest.\textsuperscript{40} Any party challenging a decision of the board must allege with particularity facts creating a reasonable doubt that “(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”\textsuperscript{41}

The \textit{Link} court noted that it was crucial that the equity claimants did not have the contractual right under the corporation’s charter to vote on the asset sale being challenged in the litigation.\textsuperscript{42} Also, in this case, the court considered that fact that “Link was insolvent, teetering on the brink of bankruptcy” to be an important factor in its decision.\textsuperscript{43} Link’s insolvency was relevant because, while directors generally owe no fiduciary duties to creditors, “in limited cases... such duties do arise.”\textsuperscript{44} In particular, where an entity is insolvent, in the sense that it “has liabilities in excess of a reasonable market value of assets held,” then directors have fiduciary duties to creditors as well as to equity claimants.\textsuperscript{45}

Critically, the court in \textit{Link} held that “the board of directors of an insolvent company may take into account the interests of creditors at the apparent expense of stockholders if, in doing so, the board meets its fiduciary duties to all relevant constituencies.”\textsuperscript{46} The court further observed that the company’s directors:

acted as they plausibly thought necessary in order to extract value for the corporation. The fact that Unit (equity) holders were left with nothing at the end . . . does not suffice to rebut the presumption that the directors were acting in the good faith exercise of their fiduciary duties, or to establish a claim of waste.\textsuperscript{47}

This case presents in sharp relief the power that directors have to make choices that benefit one corporate constituency (in this case, the creditors) at the expense of another (in this case, the residual claimants). Of great interest is the fact that, because the court found that Link Energy was insolvent at the time of the challenged asset sale, the company owed fiduciary duties simultaneously to both the firm’s equity claimants and to its debt claimants. The court therefore held that under these circumstances, the directors were free to do precisely what they did, which was to act “at the apparent expense” of the firm’s equity claimants.\textsuperscript{48} Clearly, then, the directors also were free to act “at the apparent expense” of the firm’s creditors, as long as in the process of doing so, they met their fiduciary duties “to all relevant constituencies.”\textsuperscript{49}

The \textit{Link} case is a good example of the broad point of this Article. Palpable conflicts existed between the interests of the equity holders and the interests of the fixed claimants and no decision rule exists to resolve the distributive issue. The only guidepost available for evaluating the actions of the board is an inquiry into whether the transaction approved

\begin{footnotesize}
\begin{enumerate}
\item Link, 2005 Del. Ch. LEXIS 155, at *17.
\item Id. at *17-18.
\item Id. at *20.
\item Id. at *21.
\item Id. at *22.
\item Id. at *23.
\item Id. at *33.
\item Id. at *23.
\item Id.
\end{enumerate}
\end{footnotesize}
of could reasonably be construed as maximizing the value of the firm. There simply is no sound analytical methodology that allows us to go beyond this necessarily deferential approach to reviewing the directors’ actions in order to evaluate the distributive, as opposed to the efficiency, implications of the directors’ decisions.

It is worth exploring the difficult issue of whether the favorable outcome for the defendants in this case depended, as the court suggests, at least in part on the fact that the directors had the contractual authority to sell the assets of the firm without first obtaining a vote of the equity holders. Whether or not a vote was obtained, it seems quite clear that the directors would not have been permitted to sell the assets of the firm at a discount either to themselves, to entities to which they had connections, or to third parties. Such a self-dealing transaction clearly would have been beyond the pale. It would have changed the role of the directors from that of “mere” referees of a transaction that involved a conflict among competing claimants to the firm’s resources into interested parties. There is no question that directors should not be permitted to serve as referees of transactions in which they also have an interest. Thus, it appears that the key fact in Link was the neutrality of the arbitrators, not the contractual provisions in the firm’s charter excluding the shareholders from voting.

The shareholder vote was important, however, for economic reasons more than for legal reasons. The shareholders’ equity was trading for $5.00 per share prior to the directors’ decision to agree to sell all of the assets of the firm in a transaction that was not going to result in the creditors being paid in full and the equity claimants receiving nothing. Assuming that the shareholders were acting rationally, they would have voted to reject this transaction if the usual and customary voting rights that equity claimants enjoy in the context of sales of all of a company’s assets had not been both contractually and statutorily excised. Thus, as a practical matter, the shareholders, by agreeing to an organizational form and an investment contract that did not provide them with voting rights, actually created the risk of being subjected to the transaction that wiped out the value of their investment.

Thus the Link case stands for the proposition that courts lack both the capacity and the inclination to interfere when boards of directors are making decisions that are purely

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50. However, transactions in which directors have an improper personal interest do occur, and clearly should be discouraged. Consistent with Dean Clark’s analysis, what is needed is a system to regulate such transactions that recognizes the dangers of both Type 1 and Type 2 errors (errors of bad transactions going through and errors of good transactions being screened out by the legal system). More formally, a type-one error occurs when an investigator wrongly concluded that there is a significant difference between two alternatives when the observed difference is actually due to chance (the error consists of rejecting a true hypothesis). A type-two error is making the mistake of concluding that there is no statistical difference between two alternatives when in fact, there is one (the error consists of failing to reject a hypothesis that is false). John M. Eisenberg, What Does Evidence Mean? Can the Law and Medicine Be Reconciled?, 26 J. HEALTH POL. POL’Y & L. 369, 369-82 (2001).


52. Generally speaking, the sale, lease, exchange, or other disposition of all or substantially all of a corporation’s assets is required unless the transaction is in the usual and regular course of the company’s business, particularly where the sale or other disposition of assets would leave the corporation without a significant continuing business activity. See MODEL BUS. CORP. ACT § 12.01 (2002). The same situation exists in Delaware, at least for corporations. Thus, interestingly, a shareholder vote would have been required in Link if the company had been organized as a corporation rather than as a limited liability company regardless of the provisions in the certificate of incorporation. DEL. CODE ANN. tit. 8, § 271(a) (2005). No such shareholder vote requirement appears to apply to limited liability companies.
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distributive in nature, that is to say, when boards are acting to allocate the resources of their firms in situations in which there is no theft, self-dealing, or other abuse of power. We see that fiduciary duties played no role in the case because the company was actually insolvent, and so the directors owed fiduciary duties to both the plaintiffs, equity holders, and to the group that benefited from the directors’ decision to sell all of the assets of the company, the Note holders.

2. High River Ltd. P’ship v. Mylan Labs., Inc.

Another case that brings into sharp focus the limited role that courts can play in assisting business to regulate the pervasive conflicts that exist within the firm is *High River Limited Partnership v. Mylan Laboratories, Inc.* 53 This case revolves around the attempt by Mylan Laboratories to acquire King Pharmaceuticals. Mylan made a bid for King Pharmaceuticals at a price of $16.00 per share. King shares traded after the bid at only around $12.00 per share. However, several major Mylan shareholders, including Carl Icahn, thought that Mylan Labs was offering too much for King’s shares and wanted to prevent the transaction from occurring.

Against this background, a hedge fund, Perry, Inc., entered the picture. Perry bought the shares in the target company, King Pharmaceuticals, for around $12.00 per share. If the transaction closed at the bid price of $16.00 per share, the hedge fund stood to make $26 million. In order to increase the probability that Mylan’s bid for King would be successful, Perry went into the market and purchased 26.6 million shares, or 9.9% of the voting shares of the bidding firm. Perry then entered into short sales and other transactions that made the hedge fund perfectly hedged. By selling borrowed Mylan shares in an amount equal to the shares it had purchased, changes in the value of Mylan’s shares had no effect on Perry. Perry, in other words, controlled almost 10% of the votes in Mylan without having any economic interest in the company whatsoever.

This transaction put Perry at a significant conflict of interest vis-à-vis the other Mylan shareholders. Other Mylan shareholders were skeptical about the desirability of Mylan’s proposed acquisition of King Pharmaceuticals. Clearly, at a minimum, other Mylan shareholders besides Perry, regardless of their general views about the desirability of an acquisition, wanted any acquisition by Mylan of King to take place on the best possible price and terms for the acquirer. Perry, on the other hand, only wanted Mylan to acquire King Pharmaceuticals, regardless of whether the acquisition was good for Mylan from a strategic or synergistic perspective. Perry also clearly wanted such an acquisition to take place at the highest possible price, since the higher the acquisition price, the greater the profit for Perry on its King Pharmaceutical shares.

Thus, Perry’s interests not only conflicted with, but clearly were orthogonal to, that of its fellow shareholders. 54 Except for the fact that there was no actual vote buying transaction, the arrangement was economically and functionally equivalent to vote buying.

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54. In other words, “Perry Corp. was essentially buying votes so that it could cause Mylan to enter into a deal with King which would benefit Perry Corp. arguably to the detriment of other Mylan shareholders.” See Peter Safirstein & Ralph Sianni, *Is the Fix In?—Are Hedge Funds Secretly Disenfranchising Shareholders?*, 2 *BLOOMBERG LAW REP., CORP. GOVERNANCE*, Jan. 2005, at 1, 7.
Interestingly, under current law related to corporate governance, fiduciary duties, and vote-buying, it is not at all clear that this arrangement was illegal. With regard to corporate governance, there is no legal authority for boards of directors to unilaterally nullify the voting power of any shareholder or shareholder block. It would be inadvisable to give directors such power in light of the conflicts of interest that directors face in a wide variety of contexts. As for fiduciary duties, significantly, Perry, the hedge fund that owned stock in the target company King Pharmaceuticals and had shorted shares in Mylan, was not an officer or a director or a majority shareholder in Mylan. Thus, Perry owed no fiduciary duties that would have constrained its ability to vote its shares in Mylan in precisely the way it wanted.

The vote buying issue is somewhat more complicated, but it appears that under current law it is not at all clear that what Perry did would be construed as vote buying. Even if Perry was deemed to have bought votes in Mylan, such vote buying probably was not illegal, at least under Delaware law.55

First, the arrangement here probably was not vote buying. Not every separation of voting rights from the other emoluments of share ownership involves vote buying. Here, there were a series of independent transactions that resulted in a situation in which Perry had voting rights in Mylan, without being at any economic risk for the consequences of using bad or tainted judgment in the exercise of its franchise.

However, this is not unusual. Regarding the separation of shares from votes, companies can issue non-voting shares, and they also can issue shares with super-majority voting rights without running afoul of restrictions on vote buying. Voting trusts and related sorts of arrangements similarly result in the separation of the voting rights from the other property rights associated with share ownership. Moreover, while what Perry did was extreme, the fact remains that shareholders frequently hedge their positions in the companies in which they invest, not only by trading in options, derivatives, and futures, but also simply by holding fully diversified portfolios of assets, which fully eliminate the firm-specific economic risk associated with an investment in a particular company.

Another obstacle to a finding that Perry had engaged in impermissible vote buying is dicta in the most recent Delaware case to deal with vote buying, Hewlett v. Hewlett Packard Company.56 In that case, the son of Hewlett-Packard (HP) co-founder Bill Hewlett brought a shareholder derivative suit against Carly Fiorina, HP's CEO, for buying the votes associated with 17 million HP shares controlled by Deutsche Bank in order to induce the bank to vote these shares in favor of a proposed merger between HP and Compaq, Inc. Mr. Hewlett's allegation was that in order to foster and improve Deutsche Bank's investment banking business, Deutsche Bank changed its vote. In rejecting the vote buying claim for lack of evidence,57 the court made a remark that is highly relevant

55. Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982) (holding that although a corporation's loan to the holder of its stock in return for voting as the corporation desired constituted vote buying, it was not illegal per se, as it did not defraud or disenfranchise other shareholders). See also infra note 57.


57. The court held that the "plaintiffs ... failed to prove that HP management improperly enticed or coerced Deutsche Bank into voting in favor of the merger." Hewlett, 2002 Del. Ch. LEXIS 35, at *63-64 (Del. Ch. Apr. 30, 2002). With regard to the vote buying claim, Chancellor Chandler added, "The plaintiffs can point to
to my consideration of a vote buying claim against Perry Corporation:

Shareholders are free to do whatever they want with their votes, including selling them to the highest bidder. Management, on the other hand, may not use corporate assets to buy votes in a hotly contested proxy contest about an extraordinary transaction that would significantly transform the corporation, unless it can be demonstrated... that management's vote-buying activity does not have a deleterious effect on the corporate franchise. 58

If Chancellor Chandler's assertion that shareholders are free to do whatever they want with their shares is true, then it would seem beyond doubt that Perry, in its capacity as a Mylan shareholder, was certainly free to hedge those shares and then vote. The shareholder voting controversy in High River Limited Partnership v. Mylan Laboratories, Inc., 59 presents another example of judicial incapacity to deal with, much less to resolve in any satisfactory manner, a clear conflict of interest within the firm.

Link 60 was a case in which there was a conflict among the various classes of claimants to a firm's cash flows. Mylan Laboratories 61 was a case involving a conflict among the members of a single class of claimants, Mylan's common shareholders. Two additional sorts of conflicts among this group are worth noting. Besides the conflict between Perry and the other shareholders, there was also a conflict between Carl Icahn and the other shareholders, as well as conflicts among the diversified and non-diversified Mylan shareholders.

Carl Icahn, the maverick investor who complained most vociferously about Perry's actions, had, it appears, taken a large short position in King Pharmaceuticals, the target firm that Mylan had taken steps to acquire. 62 This clearly put Icahn in a conflict of interest situation vis-à-vis his fellow Mylan shareholders. Suppose, for example, that a Mylan acquisition of King would create important synergies that would result in benefits for Mylan shareholders as well as a substantial acquisition premium for shareholders in King Pharmaceuticals. While other shareholders might prefer that Mylan succeed in acquiring King, Icahn might not. Icahn could possibly lose more on his short position in King than he would gain on his long position in Mylan if Mylan succeeded in its acquisition attempt.

Thus, while Perry's hedge made it prefer that Mylan pay too much for King, Icahn's
short position in King made him prefer that Mylan pay too little. Additionally, while Perry's hedge gave Perry an incentive to pursue a takeover of King, even where such a transaction was not in the interests of the other Mylan shareholders, Icahn's short position gave Icahn an incentive to oppose Mylan's attempt to acquire King, even where such an acquisition was in the interests of the other Mylan shareholders.

In addition to the conflicts between Mylan shareholders and Perry, Inc., and the conflicts between Mylan shareholders and Carl Icahn, there also were conflicts among the rest of the Mylan shareholders. Consider for a moment the Mylan shares owned and controlled by Mylan management. These shareholders might have preferred an acquisition of King, for selfish reasons, even if such an acquisition was not in the best interests of other Mylan shareholders, because such an acquisition would give managers more resources to control, which might make them less susceptible to a hostile takeover of Mylan. More subtly, fully diversified Mylan shareholders, like shareholders who owned Mylan stock through an investment in a mutual fund, were likely to hold shares in King Pharmaceuticals as well. These shareholders might have preferred that Mylan overpay for its King shares. Finally, as discussed above, certain Mylan shareholders might have a hedged investment, and therefore, might have been less concerned with a possible transaction involving King than other Mylan shareholders. Similar conflicts existed among the King Pharmaceuticals shareholding population as well.


Gasoline Ltd. was a closely held corporation, half of whose shares were owned by members of the Nakash family, the other half of which were owned by the Marciano clan. The two families were bickering to such an extent that the corporation had been placed in custodial status, pursuant to Section 226 of the Delaware General Corporation Law, due to the deadlock on the company's board of directors.

Due to the deadlock at both the shareholder level and the director level, there was no way for the company to act pursuant to such normal corporate formalities, such as a board of directors or shareholder approval for important transactions and decisions. When the firm got into financial difficulty, the Nakashes made a series of loans totaling $2.5 million to keep the business running. The Marcianos sued to void the loans on the grounds that these loans were interested transactions between officers and directors of Gasoline Ltd. and the company.

There was no question that these transactions were interested transactions. However, these transactions also involved an infusion of money into a firm that was in a chaotic situation due to the deadlock among the shareholders and directors and the custodial posi-

63. George W. Dent, Unprofitable Mergers: Toward a Market-Based Legal Response, 80 NW. U. L. REV. 777, 781 (1986) (suggesting that "empire-building" by corporate managers motivates many acquisitions, thereby explaining the disparity between the large gains to target firm shareholders and the small gains to acquiring firm shareholders).

64. For example, King Pharmaceutical managers might have preferred to resist a takeover, even where such a transaction was in the best interests of King's outside shareholders, because of the significant risk that they would lose their jobs if King were merged into Mylan-King. And, even if they didn't lose their jobs, they likely would have preferred to remain as top officers and directors in King to being mere underlings and functionaries in a larger corporate enterprise.

66. Id.
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The Delaware Supreme Court, in assessing the plaintiffs' challenge to these interested transactions, noted that Nakash could not utilize section 144, which articulates criteria that can be used to immunize conflict of interest transactions from judicial challenges, because section 144 requires approval either by disinterested directors or by disinterested shareholders. The court reasoned that section 144 was "realistically unavailable" to the defendants. While the outcome in Marciano is undoubtedly correct, the court's reasoning is unsatisfying. The only reason that section 144 was unavailable was because the defendants were unable to garner the necessary votes to attain the majority necessary to insulate the transaction from challenge by permitting invocation of the business judgment rule, and thereby limiting judicial review to issues of gift or waste with the burden of proof on the party attacking the transaction.

While the outcome in Marciano is undoubtedly correct, the court's reasoning is unsatisfying. The only reason that section 144 was unavailable was because the defendants were unable to garner the necessary votes to attain the majority necessary to insulate the transaction from challenge by permitting invocation of the business judgment rule, and thereby limiting judicial review to issues of gift or waste with the burden of proof on the party attacking the transaction.

It seems odd to say, as the Delaware Supreme Court did in Marciano, that the statutory remedy was unavailable to the defendants merely because the party seeking to invoke the statute was unable to obtain the votes necessary to trigger the protections afforded under the statute. The Court reasoned that "[t]he ratification process contemplated by section 144 presupposes the functioning of corporate constituencies capable of providing assents." This is true as far as it goes. But the fact is that the corporation had a corporate constituency—the Marciano family—that was perfectly capable of providing its assent. The problem was not the Marcianos' capacity to provide its assent. The problem, rather, was that the Marciano family was unwilling to provide its assent. Since the statute presupposes that corporate constituencies can approve interested transactions, logic dictates that the statute must also presuppose that corporate constituencies, such as the Marciano family, can also disapprove interested transactions.

This is exactly what happened in Marciano. The Marcianos disapproved the transaction. Their disapproval deprived the Nakashes of the ability to garner the consent of a majority of the disinterested directors or shareholders necessary to insulate the transaction from attack under the statute. This, it would seem, is precisely what the statute contemplates.

Marciano was correctly decided in spite of section 144, not because of it. The court was rather clear on this point, noting that "[t]his case illustrates the limitation inherent in viewing section 144 as the touchstone for testing interested director transactions." The critical fact in Marciano was economic, not legal. The key fact was that the Nakash family was putting money into the firm, not taking money out of it. It is extremely difficult to argue that a company receiving a cash infusion, particularly where the infusion is priced at market rates, has been injured solely by virtue of having received the cash from a particular party. In light of the corporate governance stalemate at Gasoline Ltd., it is improbable that the company could have gotten outside financing, making the defendants' loans even more important for the company.

Among the myriad possible conflicts that corporations encounter, differences

67. Id. at 404.
68. Id. at 405 n.3.
69. Id. at 404.
70. Marciano, 535 A.2d at 404.
71. Of course, if the cash is then paid out to a controlling faction, then that aspect of the transaction can be attacked separately.
abound. A strong argument can be made that we should encourage, rather than discourage, the conduct that created the conflict in *Marciano* because it involved providing a financially strapped and troubled company with capital. In an imperfect world, such transactions present two sorts of errors. The first type of error results when the party lends money to a firm on bad terms. The second sort of error results when officers and directors decline to extend credit to a financially strapped company for fear of the legal risk involved.

This latter sort of risk is likely to be more severe for two reasons. First, the risk of lending on bad terms is significantly mitigated by the fact that it is not costly or difficult to monitor the terms of the loans made by insiders, and it is not difficult to determine whether such loans are at market rates, given the plethora of information about interest rates and other aspects of capital costs.

Second, insider loans and other sorts of capital infusions are subject to acute hindsight bias. Hindsight bias describes the natural tendency to view past events as having been predictable. Hindsight bias leads those evaluating the behavior of other people to conclude that if these other people were reasonable and prudent, they would have been able to anticipate from the beginning that the events that did occur were going to occur. People are said to be biased by the knowledge of what has actually happened when evaluating the likelihood that the event would occur. Knowledge of the existence of hindsight bias will make rational insiders extremely reluctant to engage in transactions such as insider loans that will appear to have been ill-advised in hindsight, regardless of how useful and beneficial they were to the company when entered into initially.

### C. Conflicts Through a Contracting Lens

The three cases analyzed above, *Link*, *High River*, and *Marciano*, taken together, provide a useful lens through which to analyze the standard law and economics account of the role of fiduciary duties, particularly the fiduciary duty of loyalty, which operates in conflict of interest situations. These cases, which I view as quite representative of the entire universe of conflicts cases, provide strong support for the observations made by Frank Easterbrook and Daniel Fischel that there is no sharp line between the duty of care and the duty of loyalty.

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72. See generally MICHAEL ANDRÉ BERNSTEIN, FOREGONE CONCLUSIONS: AGAINST APOCALYPtic HISTORY (1994) (stating that memory, not data informs people’s views about what is likely to occur in the future); GARY SAUL MORSON, NARRATIVE AND FREEDOM: THE SHADOWS OF TIME (1994) (stating that as an event becomes more distant, its reoccurrence appears less likely).

73. EASTERBROOK & FISCHEL, supra note 3, at 103.

74. See Michael Jensen & William Meckling, Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976) (defining agency costs and explaining the effects of agency costs on the capital structure of companies). More formally, in an agency relationship, both sides anticipate, at the time the agency relationship is created, that circumstances will arise under which the agent will have incentives to act in ways that deviate from the best interests of the principal. Principals, of course, have incentives to incur monitoring costs and to provide economic incentives for their agents to act in ways consistent with the objectives of the principal. Agents also have incentives to incur costs, known as bonding costs, to lower their cost of capital by expending resources (bonding costs) in order to enable them to make a credible commitment that they will not deviate from the interests of the principles when performing their jobs. Agency costs consist of the monitoring expenditures by the principal, the bonding expenditures by the agent, and any residual loss that comes from the fact that the costs of eradicating all agency costs through expenditures on monitoring and bonding would be inefficient. Expenditures on monitoring and bonding should only be made up to the point at which the costs of additional expenditures equal expected benefits in the form of lower agency costs. At some point, it will cost
as sloth and inattention are evaluated under the rules related to the duty of care. Agency costs related to conflicts of interest issues are evaluated under the duty of loyalty. As such, it is not easy to articulate the explanation for why the legal treatment of violations of the duty of care is so different, and more deferential, than violations of the duty of loyalty.

The answer to the puzzle of why duty of care problems are handled differently than duty of loyalty problems cannot be attributed to differences in the severity of the problem. After all, investors are harmed more by slothful inattention to work that results in millions in losses than by self-dealing that results in "only" thousands of dollars in losses. Easterbrook and Fischel’s analysis, however, is not wholly consistent with this.

A satisfactory explanation for the distinction [between duty of care and duty of loyalty] may be found in the differential payoffs from breach and policing. Duty-of-loyalty problems often involve spectacular, one-shot appropriations, of the "take the money and run" sort, in which subsequent penalties through markets are inadequate. Liability rules are most helpful when other mechanisms fail. A manager on the verge of retirement is not likely to be deterred from wrongdoing by the decline in his future wage. The duty of loyalty supplements market penalties for breach in those situations where market penalties themselves might be insufficient. It is also easier for courts to detect appropriations than to detect negligence, so the costs of inquiry and error are lower.  

Easterbrook and Fischel’s analysis here is incorrect for three reasons. First, duty of loyalty problems do not “often” involve spectacular, and one-shot appropriations. Duty of loyalty cases such as Marciano do not involve one-shot appropriations. In fact, it seems more plausible that duty of loyalty issues rarely arise in the context of spectacular one-shot appropriations. It seems far more likely that the most common duty of loyalty problems present themselves in quotidian situations like determining executive compensation where those executives also are directors.

Along these lines, and clearly contrary to Easterbrook and Fischel’s assertion about the existence of a strong correlation between one-shot appropriations and duty of loyalty cases, it is also the case that we sometimes observe one-shot appropriations of huge sums in cases handled under the duty of care. No better example of the sort of “one-shot appropriation” of a huge sum to which Easterbrook and Fischel were referring exists than the one described in the recent Delaware Court of Chancery opinion in In re Walt Disney Co. Derivative Litigation. Significantly, and contrary to Easterbrook and Fischel’s de-

more than $1 to eliminate, through bonding and monitoring expenditures, $1 worth of agency costs. Where this is the case, there will be residual loss. Id.

75. EASTERBROOK & FISCHEL, supra note 3, at 103.
76. In re The Walt Disney Co. Derivative Litig., Civ. A. No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005). Michael Ovitz was hired as Disney’s President in October 1995 and shortly thereafter was appointed to its board of directors. The terms of Ovitz’s employment were largely negotiated by CEO Michael Eisner and two members of the company’s four-person compensation committee, with the help of an executive compensation consultant. Ovitz’s contract contained a severance provision that provided for both cash payments and the accelerated vesting of options if his employment was terminated without cause. Within a year of his hiring, Eisner decided to fire Ovitz. On December 12, 1996, Ovitz was terminated without cause and without any board meeting or discussion of the firing. Disgruntled shareholders sued immediately, alleging that Ovitz had breached the duty of loyalty and that the other Disney directors had breached their fiduciary duties of care and good faith. The Disney directors
piction of the distinction between duty of care cases and duty of loyalty cases, this case was decided under a duty of care standard\(^7\) in which Michael Ovitz, the "long-time friend"\(^7\) of Walt Disney Company CEO Michael Eisner, came to work for Disney for less than a year and departed with a severance package worth approximately $130 million.\(^7\)

The behavior at issue in Disney featured all of the hallmarks of a duty of loyalty violation. Not only was there an acute failure of process in Disney's corporate governance,\(^8\) there also were strong arguments that the behavior of then-Disney chair Michael Eisner reflected the venal and self-interested motivation of buying off his long-time friend. In addition, there was strikingly little evidence of any benefit to Disney from its decision to engineer a departure for Michael Ovitz that permitted him to take $130 million in shareholder wealth with him upon his departure.\(^8\)

Second, while Easterbrook and Fischel are likely correct that the disciplinary responses of the markets don't always provide redress for duty of loyalty violations, they are incorrect to imply that markets always, or even usually, provide redress for duty of care violations. There does not appear to be a market remedy for sloth or for paying insufficient attention to detail, or for the myriad other duty of care problems that plague investors.

Third, it is by no means clear, as Easterbrook and Fischel assert, that it is easier for courts to detect appropriations by insiders implicating duty of loyalty issues than it is to detect negligence. Therefore, it does not appear to be the case that the costs of inquiry and error necessarily are lower in duty of loyalty cases than in duty of care cases.\(^2\) Consider, by way of illustration, the duty of loyalty issue in the Marciano case. The appropriation at issue in that case, if there was one, would have been reflected in the interest rate and other terms of the loan agreements between the Nakashes and the company. Analyzing the loans in Marciano to determine whether there was an appropriation at all, much less the extent of any such appropriation, would have been extremely difficult. The same analysis applies to issues of executive compensation.

Interestingly, in the two cases discussed in the preceding section that were litigated to conclusion, Link and Marciano, the defendants prevailed despite the fact that an argument could be made in both cases that the defendant directors faced conflicts and may even have benefited personally as a result of the transaction that produced the conflict of

\(^{77}\) Id.\(^{78}\) Id.\(^{79}\) Id. at *190.

\(^{80}\) Ovitz severed his ties with Disney on December 27, 1996. On that day he received a letter agreement confirming that he would receive $38 million in cash compensation and the immediate vesting of 3 million stock options. The total value of this package was approximately $130 million. The December 12, 1996 press release announcing Ovitz's departure stated that "Ovitz will continue to serve as an advisor and consultant to the company and the Board of Directors," but this was "either a deliberate untruth or an incredibly irresponsible and sloppy error on Disney's part." Id. at *118-19.


\(^{82}\) Id.
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interest. In *Marciano*, the conflict was obvious: the Nakashes’ loan was arranged by the Nakash faction on the board, and the interest rates and other features, therefore, could have been set at terms favorable to the Nakashes and disadvantageous to the company. In *Link*, there was reason to believe that the board of directors, which approved a transaction clearly advantageous to the creditors and clearly disadvantageous to the equity claimants, was biased in favor of the creditors from the start.

The company’s board in *Link* was not selected by a vote of the equity claimants, which, of course, is the customary method for selecting directors. Rather, all seven of Link’s board members, including Link’s CEO, Thomas Matthews, were approved in the bankruptcy proceeding by EOTT’s former note holders. One director, J. Robert Chambers, was a managing director in the investment banking firm Lehman Brothers, which held 19.1% of the company’s equity (Units) and 19.1% of its debt. None of the other directors had any affiliation or connection with any of EOTT’s former note holders or with holders of the newly issued Notes. The plaintiffs observed, and the court appeared to agree, that “no transaction could have been worse for the equity holders,” and that it was, therefore, reasonable to infer that a “properly motivated” board of directors would not have agreed to a proposal that wiped out the value of the common equity and surrendered all of that value to the company’s creditors. Nevertheless, the court ultimately declined to intervene on the side of the equity claimants.

Critical to the analysis here is the point that the conflicts among the various claimants to the cash flows of the firm in this example cannot be avoided, reconciled, or even evaluated outside of a contacting paradigm. The only way to have avoided the conflicts described above between fixed claimants and equity claimants would be to require the firm to shed itself of one class of claimants, either equity or debt, and to try to survive on a capital structure comprised either of 100% debt or 100% equity, neither of which is likely to be optimal from the perspective of either the investors or society.

While the conflicts among equity claimants and fixed claimants are fundamental and cannot be avoided, the analysis above suggests that they can be reconciled. The reconciliation comes in the contracting and pricing mechanism. To the extent that the prices paid by the equity claimants and debt holders in a firm reflect a bargained-for exchange of risks and rewards in which the investors of various classifications are reflected in the price they pay for their securities, the conflicts that exist, while not avoided, have been reconciled satisfactorily through the pricing mechanism.

For these conflicts to be properly reconciled, the price paid by the various classes of claimants should reflect both the risk-return characteristics of the security at the time the investment is made, plus an additional amount to compensate the investor for the risk that the firm will change strategies “mid-stream” in a way that reduces the value of the claimant’s original investment. The latter risks are, of course, a form of agency cost. Thus, ex ante, the market responds to the prospect of conflicts in precisely the same way that it responds to the prospect of violations of the duty of care: through adjustments in market prices that reflect the risks that these sorts of shareholder welfare reducing behaviors will

85. Id.
86. See Jensen & Meckling, supra note 74, at 341-42.
II. DEALING WITH CONFLICTS

Conflict of interest cases implicating the fiduciary duty of loyalty are treated very differently than negligence cases implicating the fiduciary duty of care, at least according to the standard account. But it is not at all clear that this is really true. The inquiry in duty of care cases and in duty of loyalty cases is the same, in fact. The inquiry focuses on whether the decision-makers—usually the board of directors, or a subset of the board, such as a committee—acted in good faith, in the honest belief that the action taken was in the best interest of the company, and on an informed basis. Good faith, in turn, requires that the decision-makers not be faced with a conflict of interest. In other words, whether the issue involves simple negligence or palpable conflicts of interest, courts do not substitute their own views about a transaction on the part of the relevant decision-makers, as long as the decision-makers whose conduct is being challenged complied with the requisite procedure when acting.

Courts do not get involved because they lack both the competence and the inclination to replace the judgment of directors and other decision-makers with their own. In those rare cases where there is a failure of process so acute that judges are required to do more than evaluate the quality of the procedures used in a particular case, courts rely on the only tool at hand, economic analysis, to aid them in analyzing contested conduct. The economic analysis takes the form of analyzing whether the conflict of interest transaction met a market test, namely, whether the company received terms “at least as good as it would have obtained in an arm’s length transaction with a stranger.”

One insight generated by this analysis is that, at least in jurisdictions such as Delaware that have a competent judiciary in place to evaluate corporate disputes, people actually sometimes prefer ex post contracting to ex ante contracting. In other words, failure to contract is not always a result of lack of foresight. Instead, failure to contract often simply reflects a rational cost-benefit calculation by investors that the transaction costs of adding additional terms to an agreement is greater than the present value of the expected benefit that such firms might offer. The law can play an important role in reducing the costs of contracting by developing efficient menus of default rules for investors.

The analysis here also helps to explain the strange fact that shareholders and other corporate constituents systematically decline to address widely understood, profoundly costly, and recurring problems. Failure to address such problems is not due to the fact that investors and their advisors are suffering from massive debilitating cognitive defects. More likely, the problem is that there are no easy legal solutions to certain recurring and highly foreseeable problems within the corporate enterprise. At least until more is known, the current contractual strategies for confronting these problems, which include such frustrating solutions as simply ignoring the problems when contracting, may be the best among the available real-world alternatives. These problems likely go unresolved or are not solved optimally because the optimal, that is least costly, solution is through the mechanism of adjusting prices. These adjusted prices reflect the anticipated costs of such shareholder welfare-decreasing activities as excessive managerial compensation or exces-

87. ROBERT C. CLARK, CORPORATE LAW 141-262 (1986).
88. EASTERBROOK & FISCHEL, supra note 3, at 104.
sive resistance to outside acquisitions.

A simple example illustrates the point. There are a number of very low transaction cost solutions that systematically address all of the contracting problems that exist within the firm—starting with the ubiquitous problem of the abuse of minority shareholders’ rights. These simple and universal elixirs are widely known, but not always utilized, even by well-advised investors, despite the fact that it is well-known that minority shareholders in corporations risk being frozen out, and that it is difficult to protect their investments ex post (after their investments have been made). Ex ante (prior to such investments being made), however, protecting minority shareholders is a very simple matter: such investments can be protected by giving minority shareholders a “put option” that allows them to sell their shares back to the company when they wish. The price that the company must pay for their shares may be specified in the firm’s charter or bylaws. Likewise, the conditions that must be satisfied before a shareholder can exercise her option, if any, can be specified contractually beforehand.

The reason that minority shareholders do not demand that they be given put options as a precondition for investing is that these contractual provisions are costly. Creditors obviously do not like them, and require compensation for acquiescing to them, because they add an unwanted element of unpredictability regarding the equity position of the firms to which they are lending money. Majority shareholders do not like them either. These sorts of provisions give minority shareholders the power to hold up the firm, particularly in times of financial distress, by threatening to utilize their put options and demanding concessions from the firm for declining to do so. In other words, while the benefits to minority shareholders from these sorts of contractual devices are clear, the costs appear to outweigh the benefits for minority shareholders in many firms, which is why we do not observe put option provisions more often in corporate contracts.

It must not be cost effective for investors to deal with these problems or we would observe them doing so. Thus, failure to observe investors and firms contracting to address even major recurring problems that confront them does not necessarily indicate a problem with foreseeability or with any other aspect of the contracting process. Rather, the failure to utilize contractual solutions may be an indication of the cost-benefit calculus associated with adding the necessary contractual protections to the menu of protections that investors already have in place.

The absence of contractual protections for investors, of course, makes the task of courts evaluating investor lawsuits more, rather than less, complicated. Further complicating the picture is the problem that the straightforward concepts of avoidability and foreseeability just described are not static. Firms innovate all the time, and the results of such innovations create problems for investors where the innovations alter the economic relationship that such investors have with the companies in which they have invested. These problems require the intervention of some mediating institution, like a court.

IV. CONCLUSION

The analysis here disputes the well-settled account of the distinction between the

conflict of interest issues and negligence issues that face corporations in four distinct ways. First, contrary to popular wisdom, it is not clear that conflict of interest problems are more costly or severe than negligence problems.

Second, it is not clear that violations of the duty of loyalty and transactions that involve conflicts of interest, involve conduct that is worse, from a moral point of view, than conduct that is “merely” negligent. Here it is worth noting, perhaps, that in the “Purgatorio,” of Dante’s *La Divina Commedia*, when Dante places each of the seven sins leveling concentric circles, locating certain sins closer to Paradise and other sins closer to Hell, he puts sloth, the sin most akin to negligence, on Circle 5, next to avarice and greed, which are ensconced at Circle 4, but one circle closer to Hell. Of course those guilty of deliberate evil (including, interestingly, fraudulent advisers) are situated in circle 8, while insider traders and others who breach duties of trust and confidence are relegated to Circle 9.

Third, it also is clearly not the case that the costs of identifying wrongdoing are lower in duty of loyalty/conflicts cases than in duty of care/negligence cases. As the *Nakash* case clearly illustrates, it is often difficult even to discern whether the corporation benefited or is harmed in a conflicts case, at least in those cases where the corporation received consideration in the transaction with the insider.

Finally, the basic analytic distinction between negligence and loyalty is not as clear as is generally presumed. As the recent decision in *Disney* illustrates, fact patterns that involve conflicts generally are treated with the same deference as fact patterns that reflect duty of care issues concerning negligence on the part of the board.

Taken together, all of these points establish the basic argument formulated here: the very notion of conflicts of interest within the firm has been too narrowly conceived and the narrowness of current conceptions of the nature and meaning of conflicts has led to the production of confusing and imprecise law and policy in this area.

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91. According to Dante, the seven deadly sins, in order of proximity to Hell are: Pride, Envy, Wrath, Sloth, Avarice, Gluttony, and Lust. *Id.*