

DOTTORATO IN DIRITTO ED ECONOMIA

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**THE LAW OF DIRECTORS' FIDUCIARY DUTIES IN
U.S. CORPORATIONS:
AN ECONOMIC OR IDEOLOGICAL PARADIGM?**

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I. INTRODUCTION

There are multiple motivations to undertake a research of U.S. corporate fiduciary law, from historical considerations about the role of directors to philosophical reflections on “the means and ends of corporate governance.”¹ From a law and economics perspective, however, there are two primary motivations.

The first is gaining a thorough positive overview of the area of law that occupies the center stage of the American corporate governance system. Virtually all the ordinary and fundamental aspects of the corporation’s existence—such as mergers and acquisitions, transactions in control, executive and non-executive compensation policies, industrial strategies, and capital structure formation—are directors’ decisions.² As such, they necessarily involve the application and interpretation of corporate fiduciary duties.³ Viewed through this lens, corporate decisions can in fact be described as the equilibrium outcomes of multi-party games whose rules are

¹ See S. M. Bainbridge, *Director Primacy: The Ends and Means of Corporate Governance*, 97 NW. U. L. REV. 547 (2002) (arguing that unfettered directorial decision-making is the essential means of efficient corporate governance, while shareholder wealth maximization is its ultimate end).

² It is important to emphasize that in this work, the term *directors* refers jointly to the individuals who (i) are formally delegated control over the corporation (i.e., directors), and (ii) materially exercise control over the corporation (i.e., executive directors or managers).

³ See W. T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 172 (3d ed. 2009).

set by corporate fiduciary law.⁴

To make this observation more tangible, consider the impact that corporate fiduciary law can have on industrial strategies. These strategies intrinsically involve directors' decisions that reallocate corporate resources among various corporate participants, including capital providers, workers, and consumers. As a result, both the allocative and distributional effects of a corporation's industrial strategy will reflect the applicable regime of directors' fiduciary duties. For example, production strategies may need to subordinate shareholders' interests to those of employee under a fiduciary regime that requires directors to take into account the welfare of labor.⁵ On the contrary, a fiduciary regime that requires directors to maximize shareholder wealth may favor a merger transaction that consolidates a

⁴ Legal rules influence the actions of economic actors. Hence, the knowledge of legal rules helps policy-makers to predict social and economic outcomes. *See generally* D. G. BAIRD ET AL., *GAME THEORY AND THE LAW* (1st. ed. 1994).

⁵ Germany offers a concrete example of a country enforcing a similar corporate fiduciary duties regime, with board codetermination by the workforce providing the essential mechanism to make this enforcement effective. *See* J.C. Dammann, *The Future of Codetermination after Centros: Will German Corporate Law Move Closer to the U.S. Model?* 8 *FORDHAM J. CORP. & FIN L.* 607, 608 (2003) ("... German corporate law is designed to serve the interests of employees as well as those of shareholders.") Such mechanisms, however, are notably absent in the U.S. corporate system. In fact, one of the most famous cases in the history of U.S. corporate fiduciary law—*Dodge v. Ford Motor Co.*—explicitly denied the ability of corporate directors to subordinate shareholders' interests to those of employees under circumstances similar to those described in the example appearing in text. *See Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). *See also infra* Part IV.1.2.2. (discussing *Dodge v. Ford* in detail).

corporation's outstanding debt with the liabilities of a riskier counterparty, although this transaction transfers wealth from fixed claimants to shareholders.⁶ The logic behind these decisional patterns can be extended to any other fundamental corporate decision. Hence, the choice of directors' liability regime has crucial policy implications.

The second motivation for researching U.S. corporate fiduciary law is normative. Indeed, one important lesson has emerged from the 2008-2009 financial crisis: a capitalistic system driven by profit-seeking shareholders and conceived as an unregulated state of nature is not always compatible with social welfare maximization.⁷ Along this line of reasoning, several corporate scholars have recently argued that the traditional shareholder-centered paradigm of American corporate law—commonly referred to as *shareholder primacy* rule (or norm)⁸—was partially responsible for the crisis.⁹ This

⁶ For a discussion of the underpinning economic argument, *see infra* note 12 and accompanying text.

⁷ *See generally* R. A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO THE DEPRESSION (2008), J. E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 1–57 (2010); P. Krugman, *Ideology and Economics*, N. Y. TIMES, Jan. 5, 2013, available at <http://krugman.blogs.nytimes.com/2013/01/05/ideology-and-economics/?smid=fb-share> (last visited on Jan. 10, 2013).

⁸ As I discuss in detail in Part IV.1, the *shareholder primacy* rule or norm (or *shareholder wealth maximization* rule or norm) requires directors to run the business enterprise exclusively to maximize shareholders' returns.

⁹ *See* L. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDER FIRST HARMS INVESTORS, CORPORATIONS AND THE PUBLIC (2012); R. Squire, *Shareholder*

paradigm hinges on the idea that corporations are profit-making entities whose interests coincide with the shareholders' interests. But as the crisis has dramatically shown, in highly leveraged corporations (e.g., banks) focusing exclusively on shareholder wealth maximization may decrease, rather than increase, social welfare. This is because equity payoffs become asymmetric when a corporation has outstanding debt. As a result, shareholders profit from the undertaking of riskier projects at the expense of debtholders and, potentially, society as a whole—a problem that is commonly referred to by economists as *asset substitution*.¹⁰ Indeed, being shielded by limited liability and holding a residual claim on corporate profits,¹¹ shareholders expect to reap all the upside potential from riskier projects. Instead, debtholders, as fixed claimants, bear most of the downside losses from such projects.¹²

Opportunism in a World of Risky Debt, 123 HARV. L. REV. 1151 (2010); L. A. Bebchuk & H. Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010); S.M. Sepe, *Regulating Risk and Governance in Banks: A Contractarian Perspective*, 62 EMORY L. J. 101 (2012) (manuscript on file with Author).

¹⁰ The classic treatment of asset substitution is M. C. Jensen & W. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 334-37 (1976). Other corporate actions that may illegitimately transfer wealth from debtholders to stockholders include the payment of excessively large dividends, the issuance of additional debt, and the rejection of projects with a positive net present value when the benefits from such projects accrue solely to the debtholders. See C. W. Smith, Jr. & J. B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118-119 (1979).

¹¹ See *infra* Part IV.1.1.2. (discussing the economics of the shareholders' position as residual claimants)

¹² A simple example can be useful to better understand the implications of this form

Perhaps more importantly, as leverage increases, shareholders may even have incentives to undertake value-decreasing projects—a more severe form of shareholder opportunism, which is referred to as *excessive risk taking*.¹³ Indeed, higher leverage increases the amount of losses that is borne by debtholders rather than shareholders. Hence, excessive risk-taking does not just raise distributive concerns, but also allocative concerns.

of shareholders' moral hazard. Consider the case of a corporation whose capital structure is represented by equity capital, E . The directors can decide to undertake two different investments: Investment 1 or Investment 2. Investment 1 generates revenues R_L with probability p_H and 0 with probability $(1 - p_H)$. Instead, Investment 2 generates revenues R_H with probability p_L and 0 with probability $(1 - p_L)$. In this example, I make the following assumptions:

$$(A1) \quad p_H > p_L;$$

$$(A2) \quad R_L < R_H; \text{ and}$$

$$(A3) \quad p_H R_L > p_L R_H.$$

This means that: (i) Investment 2 is riskier than Investment 1; (ii) in the event of success Investment 2 delivers a higher payoff relative to Investment 1; and, finally, (iii) the present value of Investment 1 is higher than the present value of Investment 2. Under this binary investment choice, if the corporation is exclusively funded through equity, it is easy to see that Investment 1 maximizes shareholder wealth. Indeed, the undertaking of Investment 2 would reduce shareholder and corporate value by $p_H R_L - p_L R_H$. However, assume now that the capital structure also includes debt, D . Under this different capital structure, the shareholders' payoffs change as follows: under Investment 1 they expect to receive $p_H(R_L - D)$, while under Investment 2 they expect to get $p_L(R_H - D)$. Hence, whenever $D > \frac{p_H R_L - p_L R_H}{p_H - p_L}$, Investment 2 maximizes shareholder value at the expense of debtholder value and, potentially, aggregate welfare.

¹³ See Sepe, *supra* note 9, at 115 (providing an example to clarify the distinction between asset substitution and excessive risk-taking).

This analysis suggests that a corporate fiduciary system that is exclusively centered on shareholders' interests might be “systemically biased” in favor of excessive risk-taking, especially in the banking sector.¹⁴ Indeed, in this sector two circumstances tend to exacerbate the inefficiencies that may arise from shareholder primacy. First, banks' business model rests on these organizations' ability to employ high leverage.¹⁵ Second, banks—especially when they are “too big to fail”—benefit from governmental insurance and other forms of public support (i.e., safety nets) in situations of financial distress.¹⁶ While governmental insurance is unavoidable to prevent individual banking crises from disrupting the economic system as a whole,¹⁷

¹⁴ *Cf. id.*, at 106-07, 154-55 (explaining why bank shareholders have profited from such a system up to the crisis).

¹⁵ Banks' ability to use high leverage arises from the special business model they employ. Economists refer to this model as *asset transformation* because banks raise funds by issuing highly liquid claims (i.e., demand deposits) that they “transform” (i.e., invest) into illiquid assets such as medium- to long-term loans. *See, e.g.*, Philip Strahan, *Liquidity Production in 21st Century Banking* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 13798, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092846.

¹⁶ In the United States banks benefit from both federal deposit insurance, which guarantees qualified bank deposits in the event of bank failure, and several other forms of government-funded financial support (including, in the first-place, bailout interventions). *See generally* M. DEWATRIPONT ET AL., *BALANCING THE BANKS: GLOBAL LESSONS FROM THE FINANCIAL CRISIS* 3–5 (2010).

¹⁷ As famously noted by Milton Friedman and Anna Jacobson Schwartz, deposit insurance “has succeeded in achieving what had been a major objective of banking reform for at least a century, namely, the prevention of banking panics.” M. FRIEDMAN & A. J. SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES 1867–1960*, at 440 (1963).

safety nets exacerbate the excessive risk incentives on the part of bank shareholders.¹⁸ As a normative matter, this leads to question whether directors of financial corporations should take into account the consequences that their investment decisions may displace on the overall welfare before implementing those decisions.

This same kind of analysis can be exported to the real sector. Consider, for example, a firm that leaves the community in which it operates and relocates elsewhere to reduce the cost of labor. This decision will benefit the shareholders, who will enjoy the private gains arising from corporate relocation. But this increase in shareholder value might come at the expense of even higher losses imposed on the local community—for example in terms of higher unemployment rates. From a Pigouvian perspective, in such a case the corporation fails to fully internalize the negative externalities produced by its relocation decision.¹⁹ Again, this raises the normative question of what

¹⁸ See, e.g., R. S. Demsetz et al., *Agency Problems and Risk Taking at Banks* 1–2 (Fed. Reserve Bank of N.Y., Research Paper No. 9709, 1997), available at http://www.newyorkfed.org/research/staff_reports/research_papers/9709.pdf (discussing the special moral hazard problem of bank shareholders).

¹⁹ See generally A. MAS-COLELL ET AL., *MICROECONOMIC THEORY* 351-354 (1995) (providing a general illustration of the problem of externalities). Pigou has provided the basic theory of static technological externalities, suggesting that governmental intervention through the imposition of taxes and subsidies can correct this market failure. See A.C. PIGOU, *THE ECONOMICS OF WELFARE* (1920). See also MAS-COLELL ET AL., *supra*, at 354-56. The other seminal theoretical approach to the problem of externalities is owed to Coase, who argued that only efficient property rights reallocation can reduce externalities. See R. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 7 (1960). For some recent contributions, see J.M. Buchanan, *External Diseconomies, Corrective Taxes and Market Structure*, 59 AM.

the directors' conduct should be upon similar circumstances. Should directors take distributional concerns into account? Or should they do so only when this leads to a Pareto improvement in resource allocation²⁰ (i.e., a Kaldor-Hicks efficient allocation)?²¹

While the U.S. corporate fiduciary system has struggled with similar questions for more than two centuries, no definitive answer to such question emerges from my research. Instead, the pendulum of American corporate fiduciary law has oscillated around two “ideological” paradigms: the contractarian and communitarian theories of the firm.²²

ECON. REV. 174 (1969); P. Diamond, *Consumption of Externalities and Imperfect Corrective pricing*, BELL J. OF ECON. & MAN. 526 (1973).

²⁰ Pareto efficiency—named for Italian economist and sociologist Vilfredo Pareto—is the crucial equilibrium notion that has influenced the development of neoclassical economics. Under a Pareto efficient allocation no move can be made that increases the welfare of some individuals and makes no one worse off. This means that an allocation of resources in the economy is optimal if there exists no other productively feasible allocation which makes all individuals as well-off, and at least one individual strictly better off, than they were initially. *See generally* A. Feldman, *Pareto Optimality*, 3 THE NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS 811 (1998). *See also generally* MAS-COLELL ET AL., MICROECONOMIC THEORY 547 (1995).

²¹ Kaldor–Hicks efficiency (or Kaldor–Hicks criterion), named for economists Nicholas Kaldor and John Hicks, is a measure of economic efficiency that is satisfied when an allocation can be made Pareto efficient by redistributing resources from the parties that that allocation makes better off to those that it makes worse off. *See generally* A. Feldman, *Kaldor-Hicks Compensation*, in 2 THE NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS 417 (1998).

²² *See infra* sources quoted at note 133.

For contractarians, economic agents, on the one hand, rationally seek to maximize their utility and, on the other, should be free from any external constraint in their utilitarian efforts, based on the assumption that capital markets will produce efficient outcomes. The political implication of such a view is clearly antiregulatory, with the pursuing of any super-individualistic interest being seen as an illegitimate, and inefficient, intrusion by the state.²³ Under the freedom of contract advocated by contractarians, corporate law is thus reduced to a menu of default rules from which parties can choose the “best private arrangement”.²⁴ Fiduciary duties, in particular, provide the standard “contractual” terms of the shareholder-director relationship in order to mitigate the structural contracting problems faced by shareholders as

²³ The philosophical underpinning of the contractarian view of the corporation rests on the classically liberal *separation-argument*. This argument conceives of society as self-regulating, therefore excluding the need for state intervention in the private sphere. Put differently, under this view there is no need to impose authoritative norms, because such norms would naturally emerge as a result of private order agreements. For an insight on liberal political theory see J. RAWLS, A THEORY OF JUSTICE (1971); J. Rawls, *A Kantian Constructivism in Moral Theory*, J. PHIL. 515 (1980); J. Rawls, *Justice as Fairness: Political not Metaphysical*, 14 PHIL. & PUBBL. AFFAIRS (1985); R. DWORKIN, TAKING RIGHTS SERIOUSLY (1977); R. Dworkin, *Liberalism*, IN PUBLIC AND PRIVATE MORALITY (1978).

²⁴ “Default rules” identify rules that govern in the absence of contrary agreement, i.e. rules that the parties can contract around. Conversely, “mandatory rules” (or “immutable rules”, or “iron rules”) describes the set of rules that parties cannot change by private agreement, i.e., rules that govern even if the parties attempt to contract around them. For example, rules awarding expectation damages are default rules because parties can stipulate alternative damage amounts. Instead, the duty of good faith is a mandatory rule that must be respected in all kinds of contracts. See I. Ayres, *Default Rules for Incomplete Contracts*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 585 (1998).

residual claimants. Put another way, fiduciary duties are supported in equilibrium as an exclusive contract to protect shareholder value.

For communitarians, instead, corporations are social institutions tied to all their components—including shareholders, debtholders, managers, employees, and even local communities—by means of “trust”.²⁵ Hence, communitarians challenge the contractarian view of the corporation as a contractual structure in which parties can freely and efficiently bargain for their interests. For them, the contract is a limited instrument to govern multiple bilateral arrangements and the reciprocal externalities that such arrangements may generate.²⁶ Accordingly, corporate law should not exclusively focus on shareholders’ interests, but take into account the interests of all corporate participants. Operationally, this view translates into a call for a *multi-fiduciary model* of corporate relationships, in which directors’ fiduciary obligations are owed to all corporate participants.²⁷

Both these arguments present a strong ideological characterization. Contractarians adopt an efficiency argument to justify the shareholder

²⁵ See *infra* sources quoted at note 162.

²⁶ The contracting part of the Coase Theorem states that parties will find it efficient to contract around externalities in order to reach a Pareto improvement. See Coase, *supra* note 19. Communitarians, however, argue that coordination costs and, most importantly, bargaining disparities may hinder efficient coasean bargaining. See *infra* Part III.2. See also MAS-COLELL ET AL., *supra* note 19, at 364 (for an analytical treatment of multilateral externalities).

²⁷ See *infra* Part IV.2. (discussing the *multi-fiduciary* or *entity* model of directors’ fiduciary duties).

primacy rule, assuming that other corporate constituencies can contractually internalize the potential externalities that such a rule may engender. This assumption makes perfect sense under the frictionless Walrasian general equilibrium framework.²⁸ But in a world of imperfect markets and transaction costs, the contract may be an inadequate instrument to make the shareholder primacy rule compatible with the social optimum.²⁹ On the other hand, the communitarian view suffers from paternalism and, at least in some variants, confuses egalitarianism with efficiency.³⁰ But even the more economically oriented among communitarians are strongly ideological.³¹ These scholars assume that because directors have more and better information on corporate actions, they are in the best position to balance conflicting interests so to achieve Kaldor-Hicks efficiency. However, this view fails to consider that giving directors unfettered discretion over corporate decisions may produce ex-ante uncertainty and, therefore, results in increased costs of capital.

In the ensuing discussion I will explain that the evolution and

²⁸ See generally MAS-COLELL ET AL., *supra* note 19, at 519.

²⁹ Consider, for example, non-voluntary creditors (i.e., tort creditors). In this case, the contract is not just an inadequate instrument, but an unavailable instrument. The need for alternative solutions to those proposed by contractarians is self-evident upon these circumstances. See *infra* note 416 and accompanying text.

³⁰ See *infra* Part IV.2.1 (discussing the egalitarian variant of the entity model of directors' fiduciary duties)

³¹ See *infra* Part IV.2.2 (discussing the economically grounded variant of the communitarian theory of directors' fiduciary duties)

application of modern corporate fiduciary rules has reflected the unending tension between contractarians and communitarians.³² This tension, however, has been unable to produce a normative theory of corporate fiduciary duties that is analytically justified, while being freed from ideological instances. A primary reason for this failure is that such a theory does not exist, at least from a first-best perspective. Indeed, it is technologically unfeasible to devise a universal rule for administering fiduciary duties that is both ex-ante and ex-post efficient. This does not exclude, however, the possibility of theorizing and implementing second-best strategies. To this end, I suggest that courts should take the lead and identify state-contingent fiduciary rules. It is important to emphasize that to some extent this already occurs. Indeed, both academics and courts acknowledge

³² To some extent, the roots of this tension can be traced back to the debate—later dubbed as the “Great Debate”—which developed in the 1930s between Columbia Professor Adolph Dodd and Harvard Professor Merrick Berle. Cf. W.T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002). Professor Berle was the coauthor of a masterpiece of American corporate law scholarship, *The Modern Corporation and Private Property*, which was the first study to expose the modern corporation with dispersed shareholders and centralized management. See A.A. BERLE & G.C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). For Berle, corporations only existed to generate profits for shareholders. Therefore, “all powers granted to a corporation or to the management of a corporation, or to any group within the corporation . . . [are] at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.” See A.A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931). Professor Dodd fiercely disagreed. For him, the purpose of corporations was to serve broad “social” purposes, including securing jobs for employees and producing quality products for consumers. See E. M. Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1145-46, 1153-54 (1932).

that directors owe creditors fiduciary duties upon the occurrence of insolvency.³³ The much-celebrated 1991 decision of Chancellor Allen in *Credit Lyonnais Bank Netherland v. Pathe Communications Corp.* (“*Credit Lyonnais*”) moved further along this direction,³⁴ suggesting that fiduciary duties may in fact shift to creditors “in the vicinity of insolvency”.³⁵ In spite of the lack of precision of “the vicinity of insolvency” trigger,³⁶ the idea that special circumstances may command special fiduciary rules deserves appreciation.

Forging ahead in this direction, I suggest that courts should generalize this approach by identifying corporate contexts in which negative externalities are more likely to arise—such as, for example, banks, highly leveraged corporations, or quasi-insolvent corporations. They should then prescribe specific fiduciary conducts for such contexts. In practice, this would require establishing whether directors should act as fiduciaries of shareholders, creditors or any other constituency. It is obvious that the question of how this proposal should be implemented is complex and open-

³³ However, it is important to remark that whether directors’ fiduciary duties are exclusively owed to creditors or also to shareholders upon insolvency is an open issue. *See infra* text accompanying notes 381-88.

³⁴ *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, CIV. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099 (1991).

³⁵ *See id.*, at 1155.

³⁶ *See infra* text accompanying notes 419-23 (discussing criticisms of the “vicinity insolvency” trigger).

ended. What is the optimal set of special corporate contexts courts should focus on? How should courts select one context over another? These are only two of the additional questions that need to be addressed under my proposal. It is important to emphasize, however, that experience would help to answer these questions. Over time, courts would gain statistical insights on fiduciary schemes that have proven successful and be able to amend those that have not, promoting more efficient corporate relationships.

This research proceeds as follows. In Part II, I will discuss the positive conceptualization of directors' fundamental fiduciary obligations of care and loyalty, as elaborated by U.S. courts from the early nineteenth century to modern times. As I will illustrate, the traditional approach of U.S. courts has focused almost exclusively on the vertical dimension of the conflicts that corporate fiduciary duties are designed to solve: the conflict between directors and shareholders.³⁷ Economically, this approach views the

³⁷ Corporate conflicts also involve a horizontal dimension, which takes place between shareholders and other corporate participants. In its most recent articulation, the distinction between vertical and horizontal corporate conflicts is developed within the principal-agent framework that is classical of contractarian analysis. *See, e.g.,* S. Sepe, *Corporate Agency Problems and Dequity Contracts*, 36 J. Corp. L. 113, 116, 129-33 (2010); R. P. Bartlett, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 42, 61-63 (2006) (making this distinction within the venture capital context). It is worth emphasizing, however, that this distinction was originally introduced in corporate law scholarship by communitarians, who were the first to highlight that the shareholder-directors problem was not the only conflict of interest that mattered for corporate life. *See, e.g.,* L.E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992).

directors as agents and the shareholders as principals.³⁸ Within this analytical framework, conflicts may arise because the outcome of the relationship depends on unobservable actions of the agent,³⁹ who may exploit this informational asymmetry to pursue her own interest rather than the principal's best interest.⁴⁰

In this light, the requirement that directors act with care (i.e., accuracy, diligence, and expertise) in taking business decisions can be described as the “first line of protection” the law grants to shareholders as firm owners.⁴¹ In the same vein, the duty to inform⁴²—conceived as a corollary of the duty of care—provides the essential legal remedy against the informational asymmetry problems that affect the relationship between shareholders and directors. Further, the duty of control⁴³—the other corollary of the duty of care—is conceived as the coordination mechanism of the

³⁸ The seminal contribution on the agency theory of the firm is owed to Michael Jensen and William Meckling. See Jensen & Meckling, *supra* note 10, at 305. For a definitive exposition of the agency cost theory in corporate legal scholarship, see F.H. EASTERBROOK & D. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); J. Armour et al., *Agency Problems and Legal Strategies*, in *THE ANATOMY OF CORPORATE LAW* 35, 36 (Reinier Kraakman et al. eds., 2d ed. 2009).

³⁹ For simplicity, I have excluded in the discussion in the text the randomness component affecting the agent's conduct. See Jensen & Meckling, *supra* note 10, at 335.

⁴⁰ See *id.*, at 308.

⁴¹ See *infra* Part II.1.

⁴² See *infra* Part II.1.1.

⁴³ See *infra* Part II.1.2.

relationship between executive directors, who have delegated authority over the business enterprise, and non-executive directors, who supervise the use of that authority as internal monitors.

The core fiduciary duty, however, is the duty of loyalty, which—unlike the duty of care—cannot be contractually limited or eliminated.⁴⁴ As traditionally conceived, the duty of loyalty includes both a positive guidepost for directors' conduct and a negative obligation.⁴⁵ According to conventional wisdom, the positive mandate of the duty requires directors to maximize shareholder value. The negative mandate, instead, requires them to refrain from self-interested conduct—including self-dealing, conflicting transactions, misappropriation or waste of corporate assets, and excessive compensation.⁴⁶ It is self-evident that under this formulation of the duty of loyalty, there is little, if any, room for the consideration of the horizontal conflicts that may arise between shareholders and other stakeholders—including creditors, workers, and consumers.⁴⁷ Overlooking this additional order of conflicts, the traditional judicial approach to corporate fiduciary duties grants shareholders—through the positive requirement of the duty of loyalty—a primacy over other corporate constituencies. Economically, we can say that

⁴⁴ Most U.S. states permit corporations to eliminate, or at least limit, the personal liability of directors for failing to act with due care through explicit provisions in the act of incorporation. *See infra* note 94 and accompanying text.

⁴⁵ *Cf. Sepe, supra* note 37, at 165 (making a similar distinction).

⁴⁶ *See infra* sources quoted at notes 103-109.

⁴⁷ *See supra* note 37.

shareholders enjoy a monopoly power over directors' decisions. Within this approach, other corporate constituencies become—both economically and legally—“third parties” whose protection is relegated to the realm of contract.

In Part III, I will contextualize corporate fiduciary duty rules within the framework of the “ideological” debate between contractarians and communitarians. For the reasons explained above,⁴⁸ I maintain that understanding the radical differences between these two theories of the corporation is of fundamental importance for a full comprehension of the evolution of modern corporate fiduciary law and what I term the ideological dimension of corporate fiduciary duties.

In Part IV, I will then approach the problem of horizontal corporate conflicts, attempting to understand whether there exists an efficient theory of the beneficiary of directors' fiduciary duties in contexts of conflict of interests among corporate participants. To this end, I will critically discuss the three major law and economics models that have attempted to answer this question: (i) the contractarian-oriented *shareholder primacy model*, (ii) the communitarian-oriented *entity model*, and (iii) the more recent *team production model*.⁴⁹ What emerges from my research is that each of these

⁴⁸ See *supra* text accompanying notes 28-31.

⁴⁹ Vanderbilt Professor Margaret Blair and Cornell Professor Lynn Stout articulated the “team production theory” (TPT) of corporate law in an influential article they published on the Virginia Law Review in 1999. See M.M. Blair & L.A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999). While Blair and Stout's TPT clearly echoes a communitarian view of the corporation (in its economically-oriented variant), I

models is more ideology-driven than economically founded. Similarly, the judicial elaboration of corporate fiduciary duties has failed to establish general and coherent principles to solve the problem of horizontal corporate conflicts. U.S. courts have traditionally embraced a view of the corporation as a profit oriented entity—in accordance with the shareholder primacy model.⁵⁰ More recent judicial decisions, however, have advocated a conceptualization of the corporate enterprise as an individual entity separated from its shareholders—more in line with the entity model.⁵¹ The result is that a clear judicial paradigm of the horizontal dimension of the duty of loyalty has yet to be elaborated. Instead, law and economics theories and legal doctrines alike reflect more a political view than an analytical approach to corporate fiduciary law.

prefer to discuss this model as standing on its own. This is because the TPT has had much larger influence on subsequent corporate law scholarship than any other communitarian proposal. Among the articles that have directly or indirectly discussed this theory of the corporations, *see, e.g.*, J.C. Coates IV, *Team Production in Business Organizations: Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. CORP. L. 837 (1999); G.S. Crespi, *Redefining the Fiduciary Duties of Corporate Directors in Accordance with the Team Production Model of Corporate Governance*, 36 CREIGHTON L. REV. 623 (2003); D. Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000); H. Hansmann & R. Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); P. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667 (2002); A.J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002).

⁵⁰ See sources cited *infra* at Part IV.1.2.

⁵¹ See sources cited *infra* at notes IV.2.2.

In Part V, I will discuss the most significant variant to the shareholder primacy model that has been endorsed by U.S. courts: the extension of directors' fiduciary duties to creditors. I will illustrate the economic and legal arguments underpinning this variant and contextualize these arguments within the general frameworks provided by the *trust fund* doctrine⁵² and Chapter 11 of the U.S. Bankruptcy Code.⁵³ These legal frameworks share the common feature of restricting fiduciary duties to creditors to one specific contingency: the occurrence of insolvency. Insights from modern finance theory, however, suggest that framing the creditor variant of corporate fiduciary law as an insolvency-based exception to shareholder primacy is undesirable. This is because the excessive risk-taking problem that justifies the attribution of fiduciary duties to creditors upon insolvency might materialize at an earlier stage of the corporate existence, as long as a corporation is highly leveraged.⁵⁴ Chancellor Allen's decision in *Credit Lyonnais* provides a fruitful illustration of this argument.⁵⁵

⁵² Under the trust fund doctrine developed in early American corporate law the assets of a corporation facing dissolution are held in trust to the benefit of the company's creditors. *See infra* Part V.1.

⁵³ Chapter 11 of the U.S. Bankruptcy Code, which was introduced by the Bankruptcy Reform Act of 1978, regulates reorganization procedures of insolvent corporations. In contrast, Chapter 7 of the U.S. Bankruptcy Code regulates liquidation procedures. *See infra* Part V.2.

⁵⁴ *See supra* note 12 and accompanying text.

⁵⁵ *See Credit Lyonnais, supra* note 34.

Finally, in Part VI I will conclude supporting the view that a corporate fiduciary paradigm centered on shareholder primacy may prove ex-post inefficient to maximize social welfare. At the same time, multi-fiduciary models are unpractical to administer and create ex-ante uncertainty. Future research should move beyond both these paradigms and focus on identifying analytical parameters of directors' conduct that can efficiently address both horizontal and vertical corporate conflicts. My suggestion that courts should devise state-contingent fiduciary rules is a first attempt to move toward this direction.

II. THE ORIGINAL CONCEPTUALIZATION

Historically, fiduciary law finds its origins in the concept of trust. This concept developed in the English courts of equity to protect a party (the “entrustor”) from the abuses of confidence vested on another (the “fiduciary”).⁵⁶ The general principle applied by equity courts was that “if a confidence is reposed, and that confidence is abused, a court of equity shall give relief.”⁵⁷ From this early origin, the progressive evolution of fiduciary law into its modern formulation has occurred “through a jurisprudence of analogy rather than principle”.⁵⁸ By its very nature, fiduciary law is, indeed,

⁵⁶ The concept of equity is characteristic of English law and identifies those judicial decisions that are based on broad principles of common sense, rather than strict rules of law. *See generally* L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69 (1962). On the historical contest in which fiduciary law developed, *see also* D.A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 37 DUKE L.J. 879, 880 (1988); T. FRANKEL, FIDUCIARY RELATIONSHIP IN THE UNITED STATES TODAY, IN EQUITY, FIDUCIARIES AND TRUSTS (1993); R. Cooter & B.J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. Rev. 1045, 1045 (1991). For some early cases encompassing an equity concept of fiduciaries duties, *see* Bishop of Woodhouse v. Meredith, 1 Jac. & W. 204, 213 (1820) (describing English roots of fiduciary duties); Winchester v. Knight, 1 P. Wms. 406, 407 (1717) (same).

⁵⁷ Sealy, *supra* note 56, at 69-70 (quoting Lord Thurlow in *Gartside v. Isherwood*, 1 Bro. C.C. 558, 560, (1788), referring to *Filmer v. Gott*, 4 Bro. P.C. 230 (1742)).

⁵⁸ D.A. De Mott, *supra* note 56, at 881-882. In facing fiduciary law decisions, judges first identify paradigmatic cases in which fiduciary obligations apply and then compare the relationship involved in the litigation with the paradigmatic case. Only if the second relationship can be assimilated to the first, the judge will grant an extension of the fiduciary obligation to that relationship. *See id.*

situation-specific: different kinds of fiduciary relationships can be comparable among themselves, but never a true copy of one another. It is thus unsurprising that modern fiduciary law is applicable to a wide range of relationships among different parties, including principals and agents, trustors and trustees, partners, directors and officers, executors and administrators, bailors and bailees, and wards and guardians. Indisputably, however, the corporate relationship between directors and shareholders has occupied the center stage of American fiduciary law since as early as the nineteenth century.⁵⁹

The traditional common law elaboration of the relationship between directors and the corporation reconceptualizes directors as corporate fiduciaries entrusted with the exercise of powers and discretion in the best interest of the corporation.⁶⁰ Similarly to the trustee's duty to constrain her

⁵⁹ See *id.*, at 880. See also L.E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L. J. 425 (1993); R.B. Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA ST. U. L. REV. 561, 563-64 (1996).

⁶⁰ The first reference to the existence of a trust relationship between shareholders and directors occurs in the 1807 case of *Gray v. Portland Bank*: "[an incorporation is] a trust created with certain limitations and authorities, in which the corporation is the trustee for the management of the property, and each stockholder a cestui que trust according to his interest and shares". *Gray v. Portland Bank* (3 Mass. (1 Tyng), at 364 (1807)). For cases in the same line, see *Tippetts v. Walker*, 4 Mass. (1 Tyng) 595, 596 (1808); *Riddle v. Mandeville*, 9 U.S. (5 Cranch) 322 (1809); *Russel v. Clark's Ex'rs*, 11 U.S. (7 Cranch) 69 (1812); *Long v. Majestre*, 1 Johns. Ch. 305 (1814); *Moses v. Murgatroyd*, 1 Johns. Ch. 119 (1814); *Shepherd v. McEvers*, 4 Johns. Ch. 136 (1819); *Dexter v. Stewart*, 7 Johns. Ch. 52 (1823); *Koehler v. Black River Falls Iron Co.*, 67 U.S. (2 Black) 715 (1862); *Jackson v. Ludeling*, 88 U.S. (21 Wall.) 616, 624 (1874); *Coons & Braine v. Tome*, 9 F. 532, 534 (W.D. Pa. 1881).

interest to the trustor's benefit, the law requires directors to act in the exclusive interest of the corporation.⁶¹ As operationalized by courts, this mandate requires directors to refrain from undertaking corporate strategies that are in conflict with corporate interests or abusing their control position to capture personal benefits.⁶² But while these aspects of directors' fiduciary obligations are well-settled law, the interpretation of what it means exactly that directors must act in the exclusive "benefit of the corporate entity" remains an unsolved puzzle of the corporate law debate.⁶³ Because the corporate entity is a legal fiction, at its core this debate gravitates around the identification of the beneficiaries of corporate fiduciary obligations.

In this research, I will discuss the most important scholarly theories and legal doctrines that have attempted to solve "the fiduciary puzzle" and analyze the legal and economic consequences of each of these theories and doctrines. In order to develop this analysis, I start in this Part with the examination of the content of directors' basic fiduciary obligations of care and loyalty,⁶⁴ as developed by American courts and statutory legislation from

⁶¹ See T. Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1210-1211 (1995) (drawing a parallel between fiduciary law and corporate fiduciary law).

⁶² See *infra* notes 103-09 and accompanying text.

⁶³ See *infra* Part IV.

⁶⁴ It is worth noting, however, that purists of fiduciary law tend to exclude the duty of care from the world of fiduciary obligations:

That duty [of care], however, is not distinctively fiduciary; many persons, by virtue of the law or their own contractual undertakings, owe duties of care to other persons with whom they have nonfiduciary relationships. For example, motorists owe

the early nineteenth century to modern times.

1. The Duty of Care

The duty of care requires directors to conduct the corporation's affairs exerting the same degree of care that an ordinarily prudent person would exercise under similar circumstances.⁶⁵ However, while in its early

duties of care to pedestrians and to fellow motorists but are not, by virtue of these relationships, under any fiduciary constraint in their pursuit of self-interest!

DeMott, *supra* note 56, at 915.

⁶⁵ The earliest definitions of the duty of care focused on the concept of care required to avoid gross negligence. *See, e.g.,* Godbold v. Branch Bank at Mobile, 11 Ala. 191, 200 (1847); Spring's Appeal, 71 Pa. 11, 24 (1872); Williams v. Fidelity Loan & Savings Co., 142 Va. 43, 67, 128 S.E. 615, 623 (1925); Nechis v. Gramatan Gardens, 35 Misc. 2d 949, 951, 231 N.Y.S.2d 383,385 (Sup. Ct. 1962)). *See also* M. Bradley & C.A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 17 (1989); Special Project Note, *An Historical Perspective on the Duty of Care, the Duty of Loyalty and the Business Judgment Rule*, 40 VAND. L. REV. 605, 607 (1987). Some courts have specified the standard of the "ordinarily prudent persons acting under similar circumstances" by adding the prong "in the conduct of their own affairs". *See, e.g.,* Briggs v. Spaulding, 141 U.S. 132, 152 (1891); Burkhardt v. Smith, 161 Md. 398, 403, 157 A. 299, 301 (1931); Hun v. Cary, 82 N.Y. 65, 71 (1880); Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 574, 224 A.2d 634, 640-41 (1966); Hodges v. New England Screw Co., 1 R.I. 312, 348 (1850). This formulation is also the one endorsed by most American states that have codified the duty of care. *See* ALA. CODE § 10-2A-74 (1987); CAL. CORP. CODE § 309 (Deering 1977); COLO. REV. STAT. § 7-5-101 (1986); CONN. GEN. STAT. ANN. § 33-313 (West 1987); FLA. STAT. ANN. § 607.111 (West 1977 & Supp. 1986); GA. CODE ANN. § 14-2-830 (1989); HAW. REV. STAT. § 415-35 (1988 & Supp. 1989); IDAHO CODE § 30-1-35 (1980); IND. CODE ANN. § 23-1-35 (Burns Supp. 1989); IOWA CODE ANN. § 496A.34 (West Supp. 1989); KAN. STAT. ANN. § 17-6305 (Supp. 1988); LA. REV. STAT. ANN. § 12.91 (West 1969); ME. REV. STAT. ANN. tit. 13A, § 716 (Supp. 1988); MD. CORPS. & ASS'NS CODE ANN.

formulation the benchmark of diligent directorial conduct was literally that of the “ordinarily prudent and diligent man”,⁶⁶ over time this benchmark has evolved into a more articulated requirement encompassing two specific obligations: (i) the duty of being informed and (ii) the duty of control.

1.1. The Duty of Being Informed

One aspect of the duty of care that is recognized as fulfilling the modern standard of the ordinarily prudent man is the duty of being informed, which requires directors, prior to taking any business decision, to inform

§ 2-405.1 (1985 & Supp. 1989); MASS. ANN. LAWS CH. 156B, § 65 (Law. Co-op. 1988); MICH. COMP. LAWS ANN. § 450.1541 (West 1973 & Supp. 1989); MINN. STAT. ANN. § § 302A.251, 302A.361 (West 1985); MISS. CODE ANN. § § 79-4-8.30, 79-4-8.42 (1988); MONT. CODE ANN. § 35-1-401(2) (1989); NEB. REV. STAT. § 21-2035 (Supp. 1987); NEV. REV. STAT. § 78.751 (1987); N.H. REV. STAT. ANN. § 293-A:35 (1987); N.J. STAT. ANN. § 14A:6-14 (West Supp. 1989); N.M. Stat. Ann. § 53-11-35(B) (Supp. 1989); N.Y. BUS. CORP. LAW §§ 715, 717 (Mckinney 1986 & Supp. 1990); N.C. GEN. STAT. § 55-35 (1988); N.D. CENT. CODE § 10-19.1-50 (1985); OHIO REV. CODE ANN. § 1701.59 (Anderson Supp. 1987); OKLA. STAT. ANN. tit. 18, § 1031 (West Supp. 1988); OR. REV. STAT. § 60.357 (1987); R.I. GEN. LAWS § 7-1.1-33 (Supp. 1989); S.C. CODE ANN. § 33-13-150 (Law. Co-op. 1976); TENN. CODE ANN. § 48-18-301 (1988); TEX. BUS. CORP. ACT ANN. § 2.41 (VERNON 1980 & SUPP. 1989); VA. CODE ANN. § 13.1-690 (1985); WASH. REV. CODE ANN. § 23A.08.343 (Supp. 1989); WYO. STAT. § 17-1-133 (1977). *See also* REVISED MODEL BUSINESS CORP. ACT § 8.30 (1985). Finally, this is the formulation the American Law Institute's (ALI) adopts in its Principles of Corporate Governance. *See ALI Principles of Corporate Governance and Structure: Analysis and Recommendations*, Tent. Draft No. 4, 1985.

⁶⁶ *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (La. 1829) is the first case that elaborated the standard of the “man of common sense, and ordinary attention”.

themselves of any material information that is reasonably available.⁶⁷ As to the operational aspects of the duty to be informed, courts and commentators have focused on (i) the awareness of potential problems affecting the corporate enterprise,⁶⁸ and (ii) the adoption of careful decisions-making process sustained by scrupulous information-gathering activity.⁶⁹ Based on this operationalization of the duty, in *Cede & Co. v. Technicolor, Inc., Consol.*,⁷⁰ the Supreme Court of Delaware found corporate directors liable for

⁶⁷ See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125,130 (Del. 1963); *Aronson v. Lewis*, 473 A.2d 805, 812 (1984); *Smith v. Van Gorkom*, 488 A. 2d, 872 (Del. 1985). For an academic discussion of the duty to be informed, see Bradley & Schipani, *supra* note 65, at 18-19; E. L. FOLK, III ET AL. FOLK ON THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS § 141.2.1.1 (3D ED. 1992); J.C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1199 (2003).

⁶⁸ See Bradley & Schipani, *supra* note 65, at 19; S.R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 613 (1983); Special Project Note, *supra* note 65, at 611.

⁶⁹ As discussed in more detailed *infra*, *Smith v. Van Gorkom* provides the classical elaboration of this prong of the directors' duty to be informed:

A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. (...) But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information ...”.

Smith v. Van Gorkom, *supra* note 67, at 871-872.

⁷⁰ See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993). The case

breach of the duty of care for taking the uninformed decision of selling the company at a too low per-share sale price.⁷¹ This decision provides a clear example of the evolution of the duty of being informed from early American corporate law, when directors could “undertake the management of a rubber company in complete ignorance of everything connected with rubber without incurring any responsibility for the mistakes which may result from such ignorance.”⁷²

But the most significant decision on the evolution of the directors’ duty to make informed decisions is *Smith v. Van Gorkom* (also known as the Trans Union case)⁷³—a merger context case in which the Supreme Court of

concerned a civil suit brought against the directors of a company by one of its shareholders in the context of a second-stage merger.

⁷¹ The court’s statement in *Cede v. Technicolor* about the duty to be informed reads as follows:

A director's duty of care requires a director to take an active and direct role in the context of a sale of a company from beginning to end. ... A trial court will not find a board to have breached its duty of care unless the directors individually and the board collectively have failed to inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company.

Id. at 366-368.

⁷² See L. Herzel & L. Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187, 1188 (1986) (quoting *In re Brazilian Rubber Plantations & Estates, Ltd.*, 1 Ch. 425, 427 (1911)).

⁷³ *Smith v. Van Gorkom*, *supra* note 67. For an exhaustive discussion, see, e.g., R.F. Balotti & M.J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 15 (1987).

Delaware held the company's directors liable for negligent appreciation of the information at their disposal. The indexes of negligence identified by the court distinguish the case as a path breaking decision. Indeed, the court found "the business acumen of the members of the board of Trans Union [and] the substantial premium over market offered by the [bidder]"⁷⁴ irrelevant as compared to the directors' carelessness and rashness in approving the transaction. The company's chairman had exclusively negotiated the deal without preliminary informing or consulting the rest of the board. The board had approved the merger within only two hours. Further, the transaction had been executed during a meeting of the Chicago Lyric Opera, without any prior reading of the agreement on the part of the company's directors.⁷⁵ Thus, the Court focused on the board's decision-

⁷⁴ Individuals with impeccable credentials formed the board of directors. The five outside directors were a former dean of the University of Chicago Business School and chancellor of the University of Rochester, and CEOs of various other big corporations. Moreover, every Trans Union shareholder was paid \$55 per share, a premium of approximately \$20 over market price. Further, the merger agreement signed by the Trans Union directors on October 10, 1985 was not legally binding until the next January 26, 1985 and provided that if a higher offer was made within that date Trans Union was contractually free to accept it. *See Smith v. Van Gorkom, supra* note 67, at 864-870. Based on these facts, the Delaware Chancery Court had indeed rejected any liability on the part of the company's directors in the first grade of the civil process. *Id.*, at 871.

⁷⁵ Among the other elements considered by the Court to declare the negligence of the Trans Union directors, there are the following facts. First, Van Gorkom imposed the decision on the other directors as a must. Second, the board's approval of the merger was given relying solely upon Van Gorkom's 20-minute oral presentation and without any written summary of the merger's terms or other supporting documentation. Third, the board did not contact any financial consultants to obtain technical advice on the fairness of the per-share

making process rather than the final outcome of the decision, holding the directors' conduct inconsistent with the standards imposed by the duty of care as duty of being informed. As it will be discussed below, this decision shocked the corporate world, attracting much criticism for having imposed an intolerable burden on boards of directors.⁷⁶

In addition to the importance of procedural matters, *Smith v. Van Gorkom* also highlighted another aspect of the fiduciary duty of acting in an informed manner: the right of directors to rely on information provided by others.⁷⁷ This right is a direct consequence of the directors' discretion to

price offer. *See id.*

⁷⁶ On the consequences of the *Trans Union* decision, *see infra* Part II.1.3. For a critical appraisal of the decision, see D.R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 *BUS. LAW.* 1437, 1455 (1985) (describing it as "one of the worst decisions in the history of corporate law"); W.J. Carney, *The Ali's Corporate Governance Project: The Death Of Property Rights?*, 61 *GEO. WASH. L. REV.* 898 (1993) ("[C]ourts seem to have ignored the fact that the question of how much information to assemble before making a choice is itself a business decision"); B. Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 *BUS. LAW.* 1 (1985) ("The dissent in *Van Gorkom* was vigorous. The corporate bar generally views the decision as atrocious. Commentators predict dire consequences as directors come to realize how exposed they have become.")

⁷⁷ The ruling in *Smith v. Van Gorkom* highlights that under section § 141 (e) of the Delaware Code, "directors are fully protected in relying in good faith on reports made by officers." *See* DEL. CODE ANN. tit. 8, § 141(e). It is worth emphasizing that the term "report" has traditionally been traditionally interpreted in an extensive manner, as to include also reports of informal personal investigation by corporate officers. *See* *Cheff v. Mathes*, Del. Supr., 41 Del. Ch. 494, 199 A.2d 548, 556 (1964). However, in the particular circumstances of the *Trans Union* case, the Supreme Court of Delaware refused to classify the oral

delegate their discretionary power to other corporate parties.⁷⁸ Statutory provisions and case law are consistent in excluding the need for directors to personally investigate every issue taken to their attention. But after the Trans Union case, directors are required to act in good faith in delegating their authority to others, that is, take direct action if they have any reasonable doubts on the information provided.

1.2. The Duty of Control

The second set of obligations implied by the test of the ordinarily prudent man concerns the careful oversight of corporate management. According to the Business Law Section of the American Bar Association, "[a] director's duty of care relates to the director's responsibility to exercise appropriate diligence in making decisions and taking other actions, as well as in overseeing management of the corporation."⁷⁹ However, it is important to emphasize that directors are not required to exercise "the utmost diligence" in

presentation of the merger agreement made by Van Gorkom as a "report". The reason for this was that the court held the Trans Union chairman uninformed himself. *See Smith v. Van Gorkom*, *supra* note 67, at 873. On the right of directors to rely on reports of other corporate officers, *see also* *Michelson v. Duncan*, Del. Ch., 386 A.2d 1144, 1156 (1978); *aff'd in part and rev'd in part on other grounds*, Del. Supr., 407 A.2d 211 (1979); *Graham v. Allis-Chalmers Mfg. Co.*, Del. Supr., 41 Del. Ch. 78, 188 A.2d 125, 130 (1963); *Prince v. Bensinger*, Del. Ch., 244 A.2d 89, 94 (1968).

⁷⁸ Under section § 141 (c) of the Delaware Code, directors are allowed to appoint committees that can exercise delegated authority over specific corporate matters. *See* DEL. CODE ANN. tit. 8, § 141(c).

⁷⁹ Committee on Corporate Laws, American Bar Association, *Corporate Director's Guidebook* (3d ed. 2001), reprinted in 56 BUS. LAW. 1571, 1582 (2001).

carrying out their duty of control, but “merely the possession of ordinary knowledge”.⁸⁰ This means that directors are not obliged to have any particular competence besides that for which they were appointed.⁸¹ Hence, they cannot be held liable for breach of the duty of care in relation to activities that involve objective difficulties and require expertise they are not supposed to have.⁸² Put another way, directors can excuse themselves by proving that they acted to the best of their (required) ability.

1.3. *The Business Judgment Rule*

In light of the above, one could think that directors are subject to

⁸⁰ *Percy v. Millaudon*, *supra* notes 66, at 74, 78. This decision, which is among the earliest on the duty of care, concerned a charge for negligence brought against bank directors for failing to control the conduct of the bank’s president and cashier. The Court upheld the plaintiffs’ claim, announcing that:

the directors' duty to control the bank officers depended on the circumstances, that if they had no knowledge to awaken suspicion of the fidelity of the president and cashier, ordinary attention to the bank's affairs was sufficient, but that if they were aware of facts that would put prudent men on their guard, a degree of care commensurate with the evil to be avoided was required.... The test of responsibility therefore should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the agent is of so gross a kind, that a man of common sense, and ordinary attention, would not have fallen into it

⁸¹ *See id.*

⁸² It is worth observing, however, that these kinds of technical impediments are often overcome through the appointment of outside directors that have specific expertise. *See Bradley & Schipani*, *supra* note 65, at 21-22; G. W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U. LAW REV. 623 (1981).

liability for breach of the duty of care in a wide range of situations, including mere negligence.⁸³ In fact, directors are protected by the business judgment rule in the exercise of their functions. This rule consists in the “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interest of the company”.⁸⁴ This implies that in order to hold directors liable for breach of the duty of care, shareholders bear the burden of proving that directors have acted contrary to the presumption set by the business judgment rule.

While commentators have lamented the difficulty of defining the

⁸³ Only rare cases directors have been held liable for mere negligence. *See, e.g.,* Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940).

⁸⁴ *See Aronson v. Lewis, supra* note 67, at 812. However, it was not until the 1963 decision in *Graham v. Allis-Chalmers* that Delaware courts introduced the requirement that directors act in an informed manner. *See* H.R. Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 985-987 (1994). Among the most important cases on the business judgment rule, *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); *Beard v. Elster*, 39 Del. Ch. 153, 165, 160 A.2d 731, 736-38 (1960); *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979). The formulation of the business judgement rule as elaborated in *Aronson* has also been reproduced by the Model Business Corporation Act. of 1990, which defines a director's fiduciary duty in the following terms:

A director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.

2 MODEL BUSINESS CORP. ACT ANN. § 8.30(a) (1990)

boundaries of the business judgment rule (especially the two latter prongs),⁸⁵ the rule's importance in corporate fiduciary law cannot be overstated. Because of the business judgment rule, courts have traditionally refrained from intervening in the corporate life and steadily refused to second-guess directors' decisions.⁸⁶ Several rationales have been advanced to justify this judicial approach to the enforcement of the duty of care, including the better position of directors to take corporate decisions than judges,⁸⁷ judiciary

⁸⁵ For example, it has been argued that the notion of good faith included in the business judgment rule overlaps with the requirements of the duty of loyalty. See A. F. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895 (1972).

⁸⁶ See Horsey, *supra* note 84, at 977-980 (stating that at least until the mid-eighties, "the business judgment rule had been applied in such a manner as to constitute an almost per se bar to shareholder claims of directors' breach of their fiduciary duty of care"); Cohn, *supra* note 68, at 594 ("[courts] invoke the purifying balm of the 'business judgment rule' . . . to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality"); J.W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968) ("The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."); Dent, *supra* note 82, at 644-647 ("When stated in the abstract, the duty of care seems to impose a meaningful obligation on directors and officers. In practice, however, the duty has had almost no effect on corporate governance for several reasons . . ."); K. Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505 (1985) ("While rhetoric abounds regarding the standard of care to be met before this [business judgment] protection may be claimed, rarely have individual directors been held liable.").

⁸⁷ See *Dodge v. Ford Motor Co.*, *supra* note 5, at 508 ("[J]udges are not business experts").

concerns about the uncertainty around the due care standard and the severity of available sanctions, the observation that “good directors” would refuse to take office if burdened with too strict fiduciary requirements,⁸⁸ and the assumption that a too strict formulation of the duty of care could jeopardize the pursuing of shareholder wealth maximization.⁸⁹

This background helps to better understand why the decision of the Delaware Supreme Court in *Smith v. Van Gorkom* came as a real shock to both the business and academic communities.⁹⁰ This shock did not come from the court’s application of the gross negligence standard. This standard had already been applied in the few other cases in which directors had been held liable for breach of the duty of care.⁹¹ What shocked practitioners and academics alike was that the Delaware Supreme Court disregarded the

⁸⁸ By insulating directors from liability, the business judgment rule makes it easier for corporations to get qualified persons to serve on their boards. *See, e.g.*, D.J. Block et al., *Advising Directors on the D&O Crisis*, 14 SEC. REG. L.J. 130, 131-32 (1986).

⁸⁹ If managers were not allowed the protection of the business judgment rule, they would be much less inclined to pursue risky strategies in order to increase expected shareholders’ returns. *See infra* text accompanying notes 95-97.

⁹⁰ *See Smith v. Van Gorkom, supra* note 67, at 881.

⁹¹ *See, e.g.*, *DePinto v. Provident Sec. Life Ins. Co.*, 374 F.2d 37 (9th Cir. 1967) (holding directors of insurance company to have acted negligently in buying shares of second company); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) (holding that in absence of proof that directors acted in bad faith or grossly abused their discretion, courts will not interfere with their business judgment); *Penn Mart Realty Co. v. Becker*, 298 A.2d 349 (Del. Ch. 1972) (directors may be held to have breached their duty of care if the court finds them to have been grossly negligent).

outcome of the directors' decision and considered, instead, the process through which that decision was taken. Although the Trans Union shareholders received a substantial premium over market value for their shares, the court went on to scrutinize the procedure leading to that outcome, deciding that it was improper. In so acting, the court entered into the company's business affairs, substituting its own judgment to that of the company's directors. This was the real "trauma" from the Trans Union case.

Immediately after the ruling in *Smith v. Van Gorkom*, shareholders' suits against directors increased dramatically, liability insurance premiums raised to extremely high levels, and a large number of board members resigned to avoid the risk of exposure to liability.⁹² The corporate world, however, did not wait too long before reacting to what became known as the "directors' liability crisis". Several U.S. states soon enacted legislative statutes permitting corporations to eliminate, or at least limit, the personal liability of directors for failing to act with due care. The first state to issue such a statute was Indiana (in April 1986), soon followed by Delaware, which enacted section 102(b) (7) not even a year after the decision in the Trans Union case.⁹³ The same did the states of New York, Virginia and some

⁹² For an extensive discussion of the so-called "director's liability crisis", see R. Romano, *What Went Wrong With Directors' and Officers' Liability Insurance*, 14 DEL. J. CORP. L. 1, 6-7 (1989); R.E. Mallen & D.W. Evans, *Surviving the Directors' and Officers' Liability Crisis: Insurance and Other Alternatives*, 12 INS. L. ANTH. 439 (1987); S.R. Slaughter, Note, *Statutory and Non-Statutory Responses to the Director and Officer Liability Insurance Crisis*, 63 IND. L. J. 181 (1988).

⁹³ The Delaware statute enables corporations incorporated in the state to include in

other forty states.⁹⁴

their act of incorporation:

[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this Title; or (iv) for any transaction from which the director derived an improper personal benefit.

DEL. CODE ANN. tit. 8, § 102(b)(7).

⁹⁴ See ALA. CODE § 10-2A-21(f) (1987); ALASKA STAT. § 10.05.010(f) (1987); ARIZ. REV. STAT. ANN. § 10-054(A)(9), 10-005(B), 10-005(F), 10-005(G), 10-1202(A), (1987); ARK. STAT. ANN. § 4-27-202(B)(3), 4-27-850(B), 4-27-850(F) (1987); CAL. CORP. CODE § § 204(a)(10), 204.5, 204(a)(11), 317(g), 317 (i) (1988); COLO. REV. STAT. § 7-3-101(u), 7-3-101.5(9) (1987); D.C. CODE ANN. § 29-304(16) (1981); FLA. STAT. ANN. § 607.1645, 607.014(2), 607.014(7) (1988); 1988 GA. LAWS 1272, Act effective July 1, 1989, ch. 1819; HAW. REV. STAT. § 415-5(h), 415-5(g) (1987); IDAHO CODE § 30-1-54(2), 30-1-5(f) (1987), Act of Mar. 22, 1988, ch. 84, 1988 Idaho Sess. Laws, 1448; 1214, 85th Leg., § 1 (1988), ILL. ANN. STAT. ch. 32, para. 8.85 (1988); IND. CODE ANN. § 23-1-35-1(e), 23-1-37-8, -13, 23-1-37-15, 23-1-35-1(d) (1988); IOWA CODE ANN. § 491.5(8), 496A.49(13), 496A.4A(7) (1988); Kan. Stat. Ann. § 17-6002(b)(8), 17-6305(b), 17-6305(f), (1987); KY. REV. STAT. ANN. § 271A.026(12) (1987), Act effect July 15, 1988, ch. 22, 1988 Ky. Acts 460 § 2; LA. REV. STAT. ANN. § 12:24(c)(4), 12:83(A), 12:83(E), 12:83(F) (1988); ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1987); Act of Feb. 18, 1988, 1988 MD. LAWS ch. 3 (to be codified at Md. Corps. & Ass'ns Code Ann. § 2-104(b)(8), -405.2); MASS. GEN. L. ch. 156B, § S. 1502, 175th Leg., 2d Sess. § 1 (1988) (bill to 13(b)(1 1/2); MICH. COMP. LAWS § 450.1209(c), 450.1562, 450.1565 (1988); Minn. Stat. § 302A.111(4)(u), 251(4) (1988); MO. REV. STAT. § 351.355(2), (7) (1988); Act effective Apr. 9, 1988, ch. 21, 1988 NEB. LAWS 1110, § 24; NEV. REV. STAT. § 78.036(1), 78.751(2), 78.751(6)(a), 78.752 (1987); N.H. REV. STAT. ANN. § 293-A:5(VI) (1987); N.J. REV. STAT. § 14A:2-7(3) (Supp. 1987) (Act

effective Feb. 4, 1987, ch. 35, 1987 N.J. LAWS 2510, § 7 (expires Feb. 2, 1989); N.M. STAT. ANN. § 53-12-2(E), 53-11-4.1(J), 53-11-35(D) (1987); N.Y. BUS. CORP. LAW § 402(b), 722 (c), 721, 717 (b) (1988); N.C. GEN. STAT. § 55-7(11), 55-19(a) (1987); OHIO REV. CODE ANN. § 1701.59(D), 1701.13(E)(6), 1701.13(E)(7), 1701.59(E); OKLA. STAT. ANN. tit. 18, § 1006 (B)(7) (1988), 1031 (F) (1986); OR. REV. STAT. § 60.047(2)(c), 60.414 (1987); 42 PA. CONS. STAT. ANN. § 8363(b), 8364, 8365 (a) (1988); R.I. GEN. LAWS § 7-1.1-48(a)(6), 7-1.1-4.1(g) (1987); S.D. CODIFIED LAWS ANN. § 47-2-58.8, 47-2-58.6; TENN. CODE ANN. § 48-12-102(b)(3), 48-18-509 (1987); TEX. REV. CIV. STAT. ANN. art. 1302- 7.06 (1988), TEX. BUS. CORP. ACT. ANN. art. 2.02-1(R) (1988); UTAH CODE ANN. § 16-10-49.1, 16-10-4(2)(b) (1987); VA. CODE ANN. § 13.1-692.1, 13.1-704 (1987); WASH. REV. CODE § 23A.12.020(10)(d), 23A.08.025(8) (1988); WIS. STAT. ANN. § 180.305, 180.307, 180.044, 048, .049 (1987); WYO. STAT. § 17-1-202(c) 17-1-105.1(a), (c) (1987). It is important to observe that, in a few states, statutes providing limitations to directors' liability were enacted even before *Smith v. Van Gorkom* (i.e., District of Columbia).

James J. Hanks Jr. has conducted a very extensive research on exculpatory statutes, distinguishing among (i) *charter option statutes* (i.e., statutes consenting provisions in the article of incorporation to limit directors' liability—such the Delaware statute); (ii) *self-executing statutes* (i.e., direct alterations of ordinary standards of care—such as the Indiana statute); (iii) *cap on money damages statute* (i.e., combination of forms under (i) and (ii) above—only Virginia has adopted this kind of statute); (iv) *expanded indemnification statutes* (i.e., statutes consenting expanded indemnification against judgments, settlements, and expenses involving directors—such as the Florida statute); (v) *expanded non exclusivity statutes* (i.e., statutes permitting corporations to provide rights other than indemnification by charter, by-law, board resolution, contract, or otherwise—such as the Maryland statute); (vi) *alternative-sources reimbursement statutes* (i.e., statutes consenting alternative means of indemnification or insurance, including aptive insurance subsidiaries, association captives formed by industry groups, trust funds, letters of credit, guaranties, and sureties—such as the Louisiana statute), and (vii) *non stockholder constituencies statutes* (expanding the criteria that directors may consider in reaching decisions on behalf of the corporation—such as the New York statute). See J.J. Hanks Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988).

The “exculpatory statutes” enabled corporations (i.e., shareholders) to contract around the personal liability of directors,⁹⁵ with the limits of bad faith or improper benefits from a conflicting transaction (i.e., loyalty obligations).⁹⁶ The common justification for this legislative reaction is that the excessively onerous burden imposed by *Smith v. Van Gorkom* on corporate directors could challenge the capacity of corporations to attract “good directors”. In law and economics terms, the risk was that this decision could exacerbate adverse selection problems. This is because, as compared to good directors, bad directors have less to lose in terms of reputation from liability for breach of the duty of care.⁹⁷ Therefore they are more likely to accept a board appointment under a strict liability regime.

While the above explanation for the statutes’ enactment may be theoretically plausible, in practice the sudden swift in state legislation on the duty of care has engendered uncertainty in the formulation and application of the duty. This, in turn, has affected the duty’s ability to serve as an effective

⁹⁵ For a very interesting analysis of the positive effects on share price of such a limitation of directors’ liability, see Y. Brook & R.K.S. Rao, *Shareholder Wealth Effects of Directors’ Liability-Limitation Provisions*, 29 J. FIN. & QUANT. ANAL. 480 (1994).

⁹⁶ Note that there are exceptions to these limits. See, e.g., N.C. GEN. STAT. § 55-7(11) (conflict of interest between directors and the corporation does not limit the waiver of directors’ liability.)

⁹⁷ Cf. J. TIROLE, *THE THEORY OF CORPORATE FINANCE* 113 (explaining that firms with low quality projects might be more willing to accept higher interest rates because they are more likely to default on their loans and, therefore, are less affected by an increase in interest rates.)

tool to curb directors' potential misbehaviors.⁹⁸ It is also worth observing that the final draft of the *Principles of Corporate Governance* issued by the American Law Institute (hereinafter, ALI Project) endorses a fiduciary model that radically departs from the enabling model chosen by the states with respect to the directors' obligation of care.⁹⁹ The ALI's fiduciary model grants courts broad discretionary powers to intervene in corporate decisions—a mandate that clearly echoes the ruling in *Smith v. Van Gorkom*. But as this research will attempt to show the real tension between enabling and regulating conceptions of fiduciary law concerns the interpretation and application of directors' primary obligation of loyalty. The next section develops the positive analysis of the duty of loyalty and begins to illustrate the tension underlying the duty's content.

2. The Duty of Loyalty

Besides exercising their role with due care, directors' must fulfill the standards of conduct imposed by the duty of loyalty, which requires them to act in good faith in the best interest of the corporation and not in conflict of interest.¹⁰⁰ Hence, the duty of loyalty includes both a positive guidepost for

⁹⁸ See Balotti & Gentile, *supra* note 73; D.M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 97-98 (1989).

⁹⁹ AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.03- 7.10. (1992) [hereinafter ALI, PRINCIPLES OF CORPORATE GOVERNANCE]. See also W.J. Carney, *Section 40.1 of the American Law Institute's Corporate Governance Project: Restatement or Mistatement?*, 66 Wash. U. L. Rev. 239, 240-41 (1988).

¹⁰⁰ This is the formulation of the duty loyalty established in the famous case of *Guth*

directors' conduct and a negative obligation. The positive mandate of the duty imposes on directors to act in the best interest of the corporation.¹⁰¹ The

v. Loft, Inc., which concerns the foundation of the Pepsi industry. The Supreme Court of Delaware held one of the directors of Loft Inc.—a corporation engaged in the manufacturing and selling of candies, syrups, beverages and other food stuff—liable for breach of the duty of loyalty because of the misappropriation of the corporate opportunity represented by the Pepsi business. The court claimed that Guth should have refrained from the Pepsi affair, based on the fact that Loft Inc. was financially able to undertake this opportunity and the interested industry was in line with Loft Inc.'s corporate business. *See Guth v. Loft, Inc.* 5 A.2d 503 Del. 1939. The court's ruling is remarkable in depicting the essence of the duty of loyalty:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.

Id. at 510.

¹⁰¹ It is important to note that it is not infrequent for this formulation to read “in the best interest of the corporation and its shareholders.” *See, e.g., Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1264, 1280 (Del. 1988) (“[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders...”). But as I will discuss in detail in Part IV.1.2, I consider this alternative formulation has a product of ideological stand

negative mandate, instead, requires directors to refrain from, among others, self-interested conduct, including self-dealing or conflicting transactions, misappropriation and waste of corporate assets, and excessive compensation. However, as the discussion that follows will show, the application of these mandates in early as well modern U.S. corporate law has been everything but uncomplicated.¹⁰²

2.1. *Early Foundations*

Courts have traditionally hold directors liable for breach of the duty of loyalty in a variety of cases,¹⁰³ including self-dealing and conflicting transactions,¹⁰⁴ misappropriation of corporate assets for personal gain,¹⁰⁵

rather than an intrinsic feature of the positive mandate of the duty of loyalty.

¹⁰² For a detailed analysis of the historical evolution of duty of loyalty, see H. Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966).

¹⁰³ See generally R. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 55–79 (eds. 1985) (providing a thorough discussion of the duty of loyalty).

¹⁰⁴ See, e.g., *Cartwright & Bros. v. United States Bank & Trust Co.*, 23 N.M. 82, 121, 167 P. 436, 453 (1917); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921); *Dixmoor Golf Club v. Evans*, 325 Ill. 612, 616, 156 N.E. 785, 787 (1927); *Guth v. Loft*, *supra* note 100; *Simpson v. Spellman*, 522 S.W.2d 615, 619-20 (Mo. Ct. App. 1975); *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); *Pogostin v. Rice*, *supra* note 84; *Lewis v. Fuqua*, 502 A.2d 962, 966-67 (Del. Ch. 1985); *Edelman v. Fruehauf Corp.*, 798 F. 2d 882 (6th Cir. 1986); *Mills Acquisition*, *supra* note 101; *Cede v. Technicolor*, *supra* note 70.

¹⁰⁵ For misappropriation of corporate opportunities is meant either the deprivation of corporate profits through the directors' engagement in personal business ventures in the corporation's same line of business or the personal advantage directors obtain out of business

waste of corporate assets,¹⁰⁶ excessive compensation,¹⁰⁷ abuse of corporate subsidiaries,¹⁰⁸ and sale of corporate control.¹⁰⁹ However, while early decisions required directors to refrain entirely from transactions in potential conflict of interest,¹¹⁰ courts have gradually admitted these transactions if approved by disinterested directors¹¹¹ and responding to the “standard of

opportunities offered to them as representatives of the corporation. *See Guth v. Loft, supra* note 100; *Duncan v. Ponton*, 102 S.W.2d 517, 519 (Tex. Civ. App. 1937); *Raines v. Toney*, 228 Ark. 1170, 1178-80, 313 S.W.2d 802, 808-10 (1958); *Sequoia Vacuum Sys. v. Stransky*, 229 Cal. App. 2d 281, 286, 288, 40 Cal. Rptr. 203, 206 (1964); *Klinicki v. Hundgren*, 298 Or. 662, 666, 695 P.2d 906, 910 (1985); *Broz v. Cellular Info. Sys.* 673 A.2d 148, 149 (Del. 1996).

¹⁰⁶ *See, Michelson v. Duncan*, 407 A.2d 211 (Del. 1979); *Colorado Management Corp. v. American Founders Life Ins. Co.*, 145 Colo. 413, 418-19, 359 P.2d 665, 668 (1961).

¹⁰⁷ *See McKey v. Swenson*, 232 Mich. 505, 514, 205 N.W. 583, 586 (1925); *Rogers v. Hill*, 289 U.S. 582 (1933). *See also Marsh, supra* note 103, 58-60.

¹⁰⁸ *See Sinclair Oil v. Levien, supra* note 84.

¹⁰⁹ *See Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955); *Jones v. H.F. Ahmanson & Co.*, 460 P.2d (Cal. 1969). For a detailed analysis of this line of cases, see W. D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965).

¹¹⁰ This notion of the duty of loyalty was typical of the railroad fraud cases of the 1860s and 1880s. *See Hoffman Steam Coal Co. v. Cumberland Coal and Iron Co.*, 16 Md. 456 (1860); *Stewart v. Lehigh Valley R.R.*, 38 N.J.L. 505 (N.J. 1875); *Wardell v. Union Pac. R.R.*, 103 U.S. 651 (1880); *Memphis & C. R. Co. v. Wood*, 88 Ala. 630, 7 So. 108 (1889); *McKey v. Swenson, supra* note 107 at 586; *Duncan v. Ponton, supra* note ---, at 519. *See also H. Marsh, supra* note 103, at 36-37; *Carney, supra* note 76, at 927-928; *Bradley & Schipani, supra* note 65, at 25-27.

¹¹¹ Among the numerous cases on this exculpation from liability for breach of loyalty, see *Glengary Consol. Min. Co. v. Boehemer*, 28 Colo. 1, 62 P. 839 (1900);

fairness” to the corporation.¹¹² From an historical perspective, this evolution of the duty of loyalty can be explained in terms of the progressive judicial recognition of the reality of corporate affairs. Indeed, in response to the strict liability rules enforced by early American corporate law, corporations started to incorporate provisions to contract around these rules in their bylaws. That is, corporations began to allow transactions in conflict of interests whereas disinterested directors or shareholders had previously approved such

Schnittger v. Old Home Consolidated Mining Co., 144 Cal. 603, 78 P. 9 (1904); Jacobson v. Brooklyn Lumber Co., 184 N.Y. 152, 162-63, 76 N.E. 1075, 1078-79 (1906); Pennsylvania R.R. Co. v. Minis, 120 Md. 461, 87 A 1062 (1913); Cartwright & Bros. v. United States Bank & Trust Co., 23 N.M. 82, 122, 167 P. 436, 449 (1917); Corsicana Nat'l Bank v. Johnson, 251 U.S. 68, 90 (1919); Dixmoor Golf Club v. Evans, 325 Ill. 612, 616, 618, 156 N.E. 785, 788 (1927); Holcomb v. Forsyth, 216 Ala. 486, 113 so. 516 (1927); Patrons' Mut. Fire Ins. Co. of Michigan v. Holden, 245 Mich. 493, 222 N.W. 754 (1929); Newcomer v. Mountain Springs Ice & Cold. Storage Co., 63 S.D. 81, 256 N.W. 359 (1934). More recent cases include Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58 (Del. 1952); Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 87 (2d Cir. 1955); Raines v. Toney, 228 Ark. 1170, 1181-82, 313 S.W.2d 802, 810 (1958); Alcott v. Hyman, 208 A.2d 501, 506 (Del. 1965); Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971); Fliegler v. Lawrence, 316 A.2d 218, 221 (Del. 1976); Cohen v. Ayers, 596 F.2d 733, 740 (7th Cir. 1979); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987).

¹¹² Until the 1960s, however, the decision of the courts was conditioned by the prior approval of the corporation, that is, the challenged transaction was to be considered automatically voidable upon shareholders' demand. After the 1960s, however, courts established their unilateral power to decide whether a transaction was void. *See* Shlensky v. South Parkway Building Corp., 19 Ill.2d 268 at 280-281, 166 N.E. 2d 793 at 800 (1960) (first case to reflect such a change in the fairness standard); International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576 (Tex. 1963); Pappas v. Moss, 303 F. Supp. 1257, 1280 (D.N.J. 1969); *Edelman v. Fruehauf*, *supra* note 104, at 882, 886.

transactions.¹¹³ Courts upheld these corporate amendments to the rule,¹¹⁴ which led to the creation of a less strict fiduciary standard of loyalty. State legislation soon adjusted to this new standard, with the result that legal statutes began to provide multiple means to validate per se conflicting transactions.¹¹⁵ One commentator has observed that by the 1960s language

¹¹³ See Marsh, *supra* note 102, at 44-46.

¹¹⁴ *Id.*

¹¹⁵ The Delaware General Corporation Law at section 144 provides as follows:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

DEL. CODE ANN. tit. 8, § 144. See also, CAL. CORP. CODE § 820; NEV. GEN. CORP. LAW § 78.140 (modelled on the California Code); NEW YORK BUS. CORP. LAW, § 713; NO. CAR.

similar to the private amendments of the rule had been made a part of the corporate codes of some like fifteen states.¹¹⁶ Soon after, The Model Act endorsed the general trend, permitting approval or ratification of transactions in conflict of interests by either disinterested directors or shareholders.¹¹⁷ Finally, the early evolution of the duty of loyalty can be said to have prevented the “intrusion” of courts into corporate life.

2.2. *Recent Developments*

Section II.2.1 above has clarified that American law has given an increasingly narrower interpretation to the duty of loyalty. Commentators have observed that case law on the duty of loyalty has evolved into holding directors liable for the duty’s breach in just two kinds of situations: undeniable self-dealing and stolen corporate opportunities.¹¹⁸ They have also observed, however, that “[d]espite its narrow focus, the duty of loyalty has

BUS. CORP. ACT, § 55-30 (also modeled on the California Code); SO. CAR. BUS. CORP. ACT, § 12-18.16; MASS. GEN. CORP. ACT. § 450.13 (5); RH. IS. GEN. CORP. LAW, § 7-4-7; MICH. GEN. CORP. ACT § 450.13 (5); CONN. STOCK. CORP. LAW § 33-323; VER. GEN. CORP. LAW § 105; W. VA. GEN. CORP. LAW § 3081. For a detailed analysis of such statutes, see Marsh, *supra* note 103, at 47-48.

¹¹⁶ See Carney, *supra* note 76, at 928.

¹¹⁷ 1 MODEL BUSINESS CORP. ACT ANN. § 41 cmt., at 842 (2d ed. 1971).

¹¹⁸ Blair & Stout, *supra* note 49, at 298-299, 306-307 (1999). In particular, Blair and Stout highlight that the duty of loyalty is not applicable to constrain directors from taking “corporate action with mixed motives”: i.e. business decision that provide non-monetary benefits to themselves at the expense of shareholders.

teeth, and sets important substantive limits on directors' behavior".¹¹⁹ Indeed, unlike the duty of care, the duty of loyalty "has had a fairly robust career."¹²⁰ There are two basic reasons for this pivotal distinction between the two duties. First, directors cannot invoke the protection of the business judgment rule in cases involving a conflict of interest between themselves and the corporation. Second, corporate actors cannot bargain for a waiver of the duty of loyalty as they can do with the duty of care.¹²¹

Most recent judiciary trends reaffirm this distinction, by restricting the parties' ability to ratify conflicted transactions. For one thing, U.S. courts have increasingly stressed the importance of the simultaneous presence of all the indexes of ratification of a self-dealing transaction. That is, courts have refused to uphold self-dealing transactions only approved by independent directors, rather than both directors and shareholders.¹²² The reason for this approach rests on the courts' concern that officers and executive directors

¹¹⁹ *Id.* at 298.

¹²⁰ Lipson, *supra* note 67, at 1197.

¹²¹ *See supra* text accompanying notes 93-96.

¹²² *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 73 (Cal. Dist. Ct. App. 1952). Moreover, the Ali Institute reports that statutes on the fiduciary duty of loyalty of at least six states (Alabama, Alaska, California, Connecticut, Illinois, and Kentucky) expressly require some form of fairness test even in the presence of approval by disinterested directors or by shareholders. *See* Carney, *supra* note 76, at fn. 167-168. On the insufficiency of the mere approval of independent directors to assure fairness of conflict of interest transactions, see also V. Brudney, *The Independent Director – Heavenly or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); R.J. Gilson & R. Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

may exercise as much power on the board process as to negate the independency of outside directors, especially in the takeover context.¹²³ In other cases, courts have affirmed their exclusive authority to decide conflict-of-interest situations, regardless of related provisions included in by-laws or the act of incorporation.¹²⁴ This shift in the courts' attitude has gone so far that while traditionally the mere existence of a conflict did not entail transaction void, it is now upon the directors to prove the fairness of the transaction in order not to be held liable for breach of the duty of loyalty.¹²⁵

Along the same line, the ALI Project on corporate governance has rejected the "old" notion of the duty of loyalty and proposed a "new duty of

¹²³ See, e.g., *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 277 (2d Cir. 1986). The new position taken by courts with respect to takeover situations seems to go toward an expansion of the duty of loyalty that includes also directorial decisions that only provide non-monetary benefits. In this respect, former Delaware Chancellor William Allen has spoken of a third kind of fiduciary duty: the "no-entrenchment" duty. Such a duty would cover all those conflicts in which directors "have no direct pecuniary interest in the transaction but have an 'entrenchment' interest, i.e., an interest in protecting their existing control of the corporation". See W.T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1290 (2001). See also *infra* note 181.

¹²⁴ See *Holi-Rest, Inc. v. Treloar*, 217 N.W.2d 517, 525 (Iowa 1974); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 68 (D.N.J. 1982); *Flieger v. Lawrence*, 361 A.2d 218 (Del. 1976); *Aronoff v. Albanese*, 446 N.Y.S.2d 368, 370- 71 (App. Div. 1982); *Cede v. Technicolor*, *supra* note 70; *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. Ct. App. 1952).

¹²⁵ See *Edelman v. Fruehauf*, *supra* note 104.

fair dealing”.¹²⁶ This proposal supports a model that attempts to find a balance between private regulation and judicial determination of the duty of loyalty.¹²⁷ On the one hand, the ALI Project confirms the (judiciary) rule that imposes the burden of proof on directors in case of conflicts of interest. On the other hand, however, it allows to avoid such a requirement if the transaction is approved by disinterested directors *or* disinterested shareholders.¹²⁸ In this case, the burden of proof is shifted to the plaintiff, who needs to show that the transaction is "so clearly outside of the range of reasonableness" that disinterested directors could not have concluded that it was fair.¹²⁹

From this analysis, it could seem that most of the tension underlying the duty of loyalty has been driven by the difficulty of defining the exact boundaries of the duty's negative mandate, i.e., the requirement not to act in conflict of interest. In fact, as the next Chapter will explain, most of the modern debate on fiduciary law has focused on the positive mandate of the duty of loyalty, attempting to give concrete meaning to the requirement that

¹²⁶ ALI, PRINCIPLE OF CORPORATE GOVERNANCE, *supra* note 99, at § 5.10.

¹²⁷ We must observe however that in relation to different kinds of transactions involving the breach of the duty of loyalty (such as misuse of corporate property, position, and information or sale of control), the Code proposes a much stricter view and argue for a stricter judicial scrutiny. *See* W.W. Bratton, *Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law*, 61 GEO WASH. L. REV. 1084, at 1091; Carney, *supra* note 76, at 929-931.

¹²⁸ ALI, PRINCIPLE OF CORPORATE GOVERNANCE, *supra* note 99, at § 5.02(a)(1)-(2).

¹²⁹ *Id.* at § 5.02(b).

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directors must act to the exclusive benefit of the corporation.

III. CONTRACTARIANS AND COMMUNITARIANS

In this Part, I contextualize corporate fiduciary duties—and, in particular, the duty of loyalty—in the modern debate between contractarians and communitarians. As I will explain, these two “philosophical” visions are the pillars of the modern evolution and political dimension of corporate fiduciary duties.

1. The Firm in the Contractarian Perspective

The contractarian instance emerges during the 1980s as a reform, imported from economics,¹³⁰ of the traditional idea of the corporation as an

¹³⁰ The new economic theory of the firm finds its origins in the early 1970s. Since the very beginning, the theory developed two variants: the institutional variant and the neoclassical variant. The roots of the institutional variant can be traced back to the 1937 essay of Ronald Coase, *The Nature of the Firm*. See R. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). In this work, Coase analyzes firms and markets as alternative forms of contracting, identifying transaction costs as the determinants of the choice between these options. The entrepreneurial firm substitutes the market structure when the costs of organization and direction are cheaper than market transactions. The neoclassical variant, instead, radically contests the hierarchical structure of the firm. The pivotal work in this line of research is *Production, Information Costs, and Economic Organization* by Armen Alchian and Harold Demsetz, who redefined the firm as the result of voluntary exchanges among the members of a team (so-called team production model) and re-interpret hierarchy as contractual monitoring. Under this view, the coesian assumption that the firm is a non-market entity within a market economy is displaced and so is the central role of the entrepreneur as owner of the firm. See A. Alchian & H. Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972). However, the team production model still “echoes” the coesian hierarchy in delineating the role of the team production’s monitor. These residual similarities, however, disappear in the subsequent

artificial structure created through state concession,¹³¹ independent by its

evolution of the economic theory of the firm. In 1976, Michael Jensen and William Meckling publish the other fundamental work on the neoclassical elaboration, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*. Jensen and Meckling requalify the firm as “[...] a legal fiction which serves as a nexus for a set of contracting relationships among individuals”. . See Jensen & Meckling, *supra* note 10, at 310. Among the additional seminal economic contributions, see E. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POLITICAL ECON. 288 (1980); E. Fama & M. Jensen, *The Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983); R. POSNER, *ECONOMIC ANALYSIS OF LAW* (2d ed. 1977); S.N.S. Cheung, *The Contractual Nature of the Firm*, 26 J. L. & ECON. 1 (1983); O.E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975); O.E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985); V. L. Smith, *Economic Theory and its Discontents*, 64 AM. ECON. REV. 320 (1974); W.A. Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978). For a descriptive account, see H.N. Butler & L.E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); J.S. Johnston, *The Influence of The Nature of the Firm on the Theory of Corporate Law*, 18 J. CORP. L. 213 (1993); T. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301 (1993).

¹³¹ The so-called “concession theory” was imported from British law at the time when the special charter (i.e., the institution of the corporate form by the sovereign’s grant of a charter) was the dominant mode of corporate creation also in the American corporate practice. Its principles are well summarized in the 1819 decision of *Trustees of Dartmouth College v. Woodward*, where Chief Justice Marshall stated that the corporation was an “artificial being, invisible, intangible, and existing solely in contemplation of state law.” Throughout the nineteenth century, however, the concession theory gradually lost its predominant role, because of the steady increase of permissive general incorporation statutes and private formations of corporations. See G.M. Anderson & R.D. Tollison, *The Myth of the Corporation as a Creation of the State*, 3 INTL REV. L. & ECON. 107 (1983); Bratton, *Nexus of Contracts*, *supra* note 162, at 433-439; Butler & Ribstein, *supra* note 130, at 8-10; D. Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201 (1990); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. LAW 277, 280 (1998).

components, and dominated by management.¹³² Contractarians contend that the corporation is, instead, the aggregate product of various contractual relationships between its participants.¹³³ The firm is considered as a *nexus of*

¹³² The managerialist view of the corporation appeared between the 1880s and the turn of the century, in concomitance with the progressive rise of large corporations and the gradual demise of the concession theory of the firm. The novelty introduced by managerialism, with its magnification of the central role of management, was clearly a mirror of the economic reality of large corporations: managers represented the true power dominating the hierarchical structure of the firm. The managerialist vision of the firm found its apex during the 1930s, with the publication of the work of Berle and Means, *The Modern Corporation and Private Property*. See BERLE & MEANS, *supra* note 32. Berle and Means viewed the delegation of corporate powers to managers as a choice imposed by the broad dispersion of ownership in large corporations, with shareholders conceived as passive investors and managers as the true owners of the firm. Managerialism continued to dominate corporate law until the rise of the new economic theory and originated several other legal theories of the firm, both pro-managerialist and anti-managerialist. See also A.A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 32-39 (1954); A.D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977); G.C. MEANS, THE CORPORATE REVOLUTION IN AMERICA 50-51 (1962); R. NADER ET AL., TAMING THE GIANT CORPORATION 62-65 (1976); M.J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

¹³³ The legal literature on the subject is far beyond extensive. Its most prominent articulation is perhaps the work of F. Easterbrook & D. Fischel, which has been collectively reproduced in THE ECONOMIC STRUCTURE OF CORPORATE LAW. See EASTERBROOK & FISCHEL, *supra* note 38. Among the numerous other contributions, see William T., *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1399 (1993); S.M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997); B.D. Baysinger & H.N. Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); H.N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON UNIV. L. REV. 99 (1989); Butler & Ribstein, *supra* note 130;

contracts: the result of a complex system of devices, which regulate the diverse interests and purposes of shareholders, managers, creditors, employees and other corporate participants.¹³⁴ Under this view, it follows that corporate law should not have any mandatory character, but just default nature.¹³⁵ That is, corporate law should simply provide standard-form contracts, freely rectifiable or modifiable by the parties' agreement.

The contractarian perspective entails an individualistic conception of the corporation, based on the assumptions that economic agents, on the one

R. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 49 (1984); R.E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983); N. Wolfson, *The Modern Corporation: Free Markets Versus Regulation* (1984). For a critical approach, see L.A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989); R. Romano, *Comment on Easterbrook and Fischel, "Contract and Fiduciary Duty"*, 36 J. L. ECON. 447 (1993). It is also worth emphasizing that some commentators consider contractualism as a new version of the "aggregate theory" of the firm dating back to the beginning of the century. This theory opposed the idea of corporations as shareholder-centered institutions originating by private initiative to the then dominant conception of corporations as artificial entities created by the state. See Bratton, *The New Economic Theory of the Firm*, *supra* note 162, at 1489-1490, P.N. Cox, *The Public, The Private and the Corporation*, 80 MARQ. L. REV. 391 (1997).

¹³⁴ The use of the terms "contract" or "contractual" in the contractarian theory is to be understood in its economic rather than legal meaning, that is, as identifying "long-term relationships characterized by asymmetric information, bilateral monopoly, and opportunism". See S. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 10 (2002). See also A. Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472 (1980).

¹³⁵ For a definition of default rules, see *supra* note 24.

hand, rationally seek to maximize their utility and, on the other, should be free from any external constraint in their utilitarian efforts.¹³⁶ The political implication of such a view is clearly antiregulatory and opposes any interference by the state into the existence of corporations. Put another way, freedom of contract reduces corporate law to a private matter, with the pursuing of any super-individualistic interest being seen as an illegitimate intrusion by the state into private autonomy.¹³⁷

The “contractarian firm” combines individualism and contract so that corporate relationships are solely the product of voluntary exchanges, which are designed to achieve the best possible arrangement for the many self-interested components of the corporation. From this perspective, cooperation among firm participants becomes a means to the end of productivity and profit maximization. As a consequence, mutual consent replaces hierarchy. Shareholders delegate decisional authority to directors and managers, who are conceived as shareholders’ “agents”.¹³⁸ Directors and managers, on their

¹³⁶ *But see* Cox, *supra* note 133, at 394, 415. Cox views “the neoclassical normative commitment” as “collectivist, even organic”, that is, a theory of “the common good”, identified with the mutual welfare of the participants to the corporation. *See also* G. Lawson, *Efficiency and Individualism*, 42 DUKE L.J. 53, 83-96 (1992) (proposing an analogous view of contractarianism).

¹³⁷ *But see* L.A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989), at 1409 (arguing that “[...] deregulators do not have a monopoly over the contractual framework of analysis” and acknowledging the existence of “public aspects of the private firms”).

¹³⁸ *See* EASTERBROOK & FISCHER, *supra* note 38, at 69.

turn, exercise this delegated authority to increment firm profits, in exchange for contractually established compensation and some other benefits.¹³⁹ In the same vein, employees accept to be subordinated to the discretionary power of directors and managers and receive a fixed wage in exchange.¹⁴⁰ In brief, all the components of the firm (including creditors) are entrenched in a net of corporate contracts.¹⁴¹ The actual specification of the various corporate contracts depends on several variables, including the size of the firm, the identity of both managers and investors, and the specific economic activity that the corporation carries out.¹⁴² In other terms, the complex relationship among corporate participants is adaptive; and it could not be otherwise, this relation being the result of voluntary arrangements.¹⁴³

Corporate contracting, however, is not inexpensive. Composing the

¹³⁹ *See id.*

¹⁴⁰ On the corporate contract of employees, see C. Chang, *Capital Structure as an Optimal Contract Between Employees and Investors*, 47 J. FIN. (1992)

¹⁴¹ From a contractarian perspective, creditors are conceived as contractual suppliers of capital. In this sense, their relationship with the firm is “contractual”: they provide money in exchange for a payment at interest. But the relationship is also contractual in the sense that creditors bargain for “incidents of ownership”, i.e., control. *See* W. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 102, 171.

¹⁴² *See* F.H. Easterbrook and D.R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1427 (1989).

¹⁴³ *Id* at 1428-30 (observing that “[...] all the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the interested parties [...] it is unimportant that they may not be 'negotiated'; the pricing and testing mechanisms are all that matter....”).

different, and often contrasting, interests of corporate participants and monitoring their activity result in *agency costs*. These are the costs arising in any relationship, in which a party, i.e., the principal, delegates authority to another, i.e., the agent, to perform some services.¹⁴⁴ Agency costs arise because of the inevitable conflicts of interest between the principal and the agent, who exert unobservable actions and therefore has incentives to pursue her own interests rather than the principal best interest.¹⁴⁵ Because of agency costs and other transaction costs, corporate contracts are inherently

¹⁴⁴ See Jensen & Meckling, *supra* note 10, at 308.

¹⁴⁵ The expression “agency costs” was first introduced by Jensen and Meckling to define the costs incurred by the principal and the agent in any agency relationship:

If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring *monitoring costs* designed to limit the aberrant activities of the agent. [emphasis added] In addition in some situations it will pay the agent to expend resources (*bonding costs*) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. [emphasis added]... [But even after incurring these costs] there will [still] be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is also a cost of the agency relationship, and we refer to this latter cost as the “*residual loss*”. [emphasis added] We define agency costs as the sum of: 1) the monitoring expenditures by the principal, 2) the bonding expenditures by the agent, 3) the residual loss.”

Jensen & Meckling, *supra* note 10, at 308.

incomplete.¹⁴⁶ In response, contractarians argue that contractual gaps should be filled by reference to the “hypothetical bargaining approach”—the agreement that the majority of parties would have reached in an ideal world of no contracting costs and symmetric information.¹⁴⁷ Under this view,

¹⁴⁶ See Alchian & Demsetz, *supra* note 130; Grossman S. & Stiglitz J, *Information and Competitive Price Systems*, 66 AM. ECON. REV. PAPERS & PROC. 246 (1976); A. Schwartz & R. E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 605-08 (2003); R. E. Verrecchia, *Consensus Beliefs, Information Acquisition, and Market Information Efficiency*, 70 AM. ECON. REV. 874 (1980); J. Gordon & L.A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985).

¹⁴⁷ On the “hypothetical bargaining approach”, see EASTERBROOK & FISCHER, *supra* note 38, at 14-15, 20-21; C.J. Goetz & R.E. Scott, *The Limits of Expanded Choice: An Analysis of the Interaction between Express and Implied Contract Terms*, 73 CAL. L. REV. 283-297; C.J. Goetz & R.E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967 (1983); R.E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641 (2003); B.A. Hermalin & M.L. Katz, *Judicial Modification of Contracts between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J. LAW. ECON. AND ORG. 230 (1993); Clark, *supra* note 103; W.A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1522 (1982). For an economic perspective, see P. Aghion & P. Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992); O. Hart & J. Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988); T.Y. Chung, *Incomplete Contracts, Specific Investments, and Risk Sharing*, 58 REV. ECON. STUD. 1031 (1991); P. Aghion et al., *Renegotiation Design With Unverifiable Information*, 62 ECONOMETRICA 257 (1994). Yet, the assumption that implementing the ideal contract corresponds to the agreement the majority of parties would choose has raised criticism. See I. Ayres & R. Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); I. Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTER. L.J. 1 (1993); I. Ayres & R. Gertner, *Strategic Contractual Inefficiency and the Optimal Choices of Legal Rules*, 101 YALE L.J.

standard form terms substitute consent in situations of contractual incompleteness, with the dominant approach among contractarians being that the maximization of wealth is the agreement most parties would agree upon in conditions of perfect contracting. Mandatory rules are therefore justified only to the extent that they satisfy this condition.¹⁴⁸ But given the difficulty of such a configuration of mandatory rules, contractarians choose defaults over mandatory rules. They argue that only by providing a set of non-mandatory standard-form provisions, corporate law can facilitate the private contracting process and thus make the achievement of Pareto efficiency possible.¹⁴⁹ The underlying assumption is that only parties negotiating around default rules can attain an optimal allocation of rights, whereas parties limited by mandatory rules can only achieve sub-optimal allocations. This is because “gap-filling” rules allow parties a broad domain of freedom of

729 (1992); A. Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Contracts and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992).

¹⁴⁸ See Easterbrook & Fischel, *supra* note 142, at 1433 (suggesting that the imposition of mandatory laws make sense “only when one is sure that the selected term will increase the joint wealth of the participants—that is, that it is the term that the parties would have selected with full information and costless contracting.”). See also F.H. Easterbrook & D.R. Fischel, *Mandatory Disclosure and the Protection of the Investors*, 70 VA. L. REV. 699 (1984); L.A. Bechuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Bechuk, *supra* note 137, at 1410-1413; R. Cranswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361 (1991).

¹⁴⁹ See *supra* note 20 (defining Pareto efficiency).

contract, which is, instead, displaced under a set of “rules of iron”.¹⁵⁰

Within this analytical framework, the role and duties of corporate directors is of fundamental importance. As noted above, contractarians conceive of directors and other corporate officers as a class of corporate participants that is contractually entrenched with all the other firm’s components. Nonetheless, it is the relationship between directors and shareholders that is at the core of the contractarian analysis.¹⁵¹ This relationship is modeled on the assumption that equity investors bear the risk of business failure and are entitled to marginal rewards of success.¹⁵² Based on this assumption, directors should exercise their discretionary power to

¹⁵⁰ An important exception to this conceptualization of legal rules is given by the existence of externalities—negative effects produced by a contract toward third parties and may, therefore, require correction through mandatory rules. *See* Easterbrook & Fischel, *supra* note 142, at 1436-1442 (pointing out that decisions not to reveal certain corporate information and decisions to resist takeovers involve significant externalities, which may justify the imposition of mandatory rules on disclosure duties and resistance to takeovers.) On externalities in general, *see supra* note 19.

¹⁵¹ For an economic background, *see* M.C. Jensen & J.B. Warner, *The Distribution of Power Among Corporate Managers, Shareholders and Directors*, 29 J. FIN. ECON. 3 (1988).

¹⁵² To this extent, the position of shareholders could apparently be assimilated to that of “owners of the firm”, in the sense that their investment in the corporation presents ownership-like features. In the contractarian analysis, however, the property rights of shareholders are residual: shareholders are only entitled to what is left after all the other firm claimants have been paid, “but they get all of what is left.” *See* EASTERBROOK & FISCHEL, *supra* note 38, at 69.

maximize shareholders' wealth.¹⁵³ Such “contractual” exchange between the parties is designed to solve the problem of alignment between their (potentially) conflicting interests.¹⁵⁴ In a simplified description, shareholders vest directors with discretion in order to reduce the costs of monitoring and obtaining information about corporate matters. And fiduciary law—in particular, the duty of loyalty—provides standard contractual terms to ensure that directors exercise their discretionary power in favor of shareholders and shareholders alone.¹⁵⁵ The fact that the contract between shareholders and directors is not always explicit, or that its terms are drafted by directors and articulated in corporate charters or bylaws substantially ignored by equity investors, does not change the contractual nature of the relationship. As long as a voluntary arrangement can be identified, there is a contract between the parties. And the investors' purchase of shares cannot be otherwise qualified than as a contract.¹⁵⁶

¹⁵³ See *infra* Part IV.1.1.2. (expanding the analysis of the residual claimant argument in favor of shareholder primacy).

¹⁵⁴ See Easterbrook & Fischel, *supra* note 142, at 1418-1420; Fama, *supra* note 130, at 292-293; B. MANNING, *LEGAL CAPITAL* 12 (2d ed. 1981).

¹⁵⁵ See Easterbrook & Fischel, *supra* note 142, at 1418-1420.

¹⁵⁶ American case law confirms the contractual view of the relationship between original owners or management of companies that go public and shareholders. See, e.g., *Er Holding, Inc. v. Norton Company*, 735 F.Supp. 1094 (D.C. Ma. 1990), in which the District Court of Massachusetts stated: “the corporate by-laws constitute a contract between the corporation's owners—the shareholders—and its managers, the Board”. However, we must also account for opposite decision, see, e.g., *City Capital Assocs. Ltd. P'ship v. Interco, Inc.*, 551 A.2d 787, 797 (Del. Ch. 1988) (arguing against the voluntariness of shareholders'

Under this view, corporate fiduciary duties—traditionally conceived as mandatory terms of the relationship between shareholders and directors¹⁵⁷—become subject to private ordering. Fiduciary duties are merely one set of rights for which corporate actors can bargain for.¹⁵⁸ Their default provision is justified because of the high costs of anticipating and drafting the potential contingencies affecting the shareholder-director relationship.¹⁵⁹ In this light, the “standard duties” of care and loyalty serve the function of mitigating contracting costs. That is, mandatory fiduciary rules become default rules for “completing incomplete bargains in a contractual structure”,¹⁶⁰ which the parties are free to accept or contract around.¹⁶¹

choices).

¹⁵⁷ In modern corporate fiduciary law, this only applies to the duty of loyalty, since the duty of care can be eliminated or mitigated through an express provision included in the act of incorporation. *See supra* Part II.2.

¹⁵⁸ EASTERBROOK & FISCHER, *supra* note 38, at 12, 90-93; Butler & Ribstein, *supra* note 130, at 29-33; Lipson, *supra* note 67, at 1199; J.R. Macey & G.P. Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. TORONTO L.J. 401 (1993).

¹⁵⁹ On the cost of fiduciary duties, *see also* Clark, *supra* note 103; K.B. Davis, *Judicial Review of Fiduciary Decisionmaking--Some Theoretical Perspectives*, 80 NW. U. L. REV. 1, 27-29 (1985). Beside private-ordered fiduciary duties and standard-form fiduciary duties, corporate scholars underline that parties can also rely on market devices to align their divergence of interests. *See* EASTERBROOK & FISCHER, *supra* note 38, at 91-92; Butler & Ribstein, *supra* note 130, at 29; W.A. Klein & K.B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON 615 (1989).

¹⁶⁰ *See* EASTERBROOK & FISCHER, *supra* note 38, at 92.

¹⁶¹ *See e.g.*, F.A. Easterbrook & D.R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, at 703-704 (1982); C.J. Goetz & R.E. Scott, *Principles of Relational*

2. The Firm in the Communitarian Perspective

The communitarian “reform” can be associated to the explosion of hostile takeovers activity during the 1980s.¹⁶² Takeovers involve the offer of

Contracts, 67 VA. L. REV. 1089 (1981); J.H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995).

¹⁶² Lyman Johnson, David Millon, and Lawrence Mitchell have been among the most vocal proponents of the communitarian position, which they have elaborated in a series of articles. See L. Johnson, *Corporate Takeovers and Corporations: Who are They For?*, 43 WASH. AND LEE L. REV. 781 (1986); L. Johnson, *State Takeover Statutes: Constitutionality, Community, and Heresy*, 45 WASH. & LEE L. REV. 1051 (1988). L. Johnson, *The Delaware Judiciary and the Meaning of Corporate Law*, 68 TEX. L. REV. 865 (1990) [hereinafter Johnson, *The Delaware Judiciary*]; L. Johnson, *Making (Corporate) Law in a Skeptical World*, 49 WASH. & LEE L. REV. 161 (1992); Millon, *supra* note 131; D. Millon, *Communitarians, Contractarians and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993) [hereinafter Millon, *Communitarians, Contractarians*]; D. Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991) [hereinafter, Millon, *Redefining Corporate Law*]; L. Johnson & D. Millon, *The Case Beyond Time*, 45 BUS. LAW 2105 (1990); L.E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990); L.E. Mitchell, *The Cult of Efficiency*, 71 TEX. L. REV. 217 (1992); L.E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263 (1992) [hereinafter Mitchell, *A Critical Look*]; L.E. MITCHELL, *PROGRESSIVE CORPORATE LAW, NEW PERSPECTIVES ON LAW, CULTURE, AND SOCIETY* (ed. 1995) [hereinafter MITCHELL, *PROGRESSIVE CORPORATE LAW*].

On various aspects of the communitarian theory, see also V. Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C.L. Rev 595 [hereinafter Brudney, *Contract and Fiduciary Duty*]; V. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1407 (1985) [hereinafter Brudney, *Corporate Governance*]; J.N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1539 (1989); M.A. O'Connor, *How Should We Talk About Fiduciary Duty?: Directors' Conflict-of-Interest Transactions and the ALI's Principles of Corporate Governance*, 61

generous premiums to target companies' shareholders in order to obtain voting control regardless of incumbent management's approval. But the takeover activity of the 1980s was essentially designed to "bust-up" target companies, meaning that it was common for bidders to liquidate or radically restructure target companies immediately after the acceptance of a takeover offer.¹⁶³ Bust-up takeovers intrinsically imply employees' layoffs, plant closings, disruption of existing commercial relationships, and, more generally, loss of economic and social benefits. The concerns raised by these circumstances opened the way to the emergence of the egalitarian instance of

GEO. WASH. L. REV. 954 (1993); J.W. Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988); L.D. Solomon, *Humanistic Economics: A New Model for the Corporate Constituency Debate*, 59 U. CINN. L. REV. 321 (1990); K. Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991).

For a criticism of the neoclassical theory of the firm, see W. Bratton Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989) [hereinafter, Bratton, *The New Economic Theory of the Firm*]; W. Bratton Jr., "Nexus of Contracts" Corporation: A Critical Appraisal, 74 CORNELL L. REV. 407 (1989) [Bratton, *Nexus of Contract*]; W.W. Bratton, Jr., *The Economic Structure of the Post-Contractual Corporation*, 87 NW. L. REV. 180 (1992).

¹⁶³ See D. Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 WASH. AND LEE L. REV. 903 (1988); J. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 2-7 (1986) (on bust-up takeovers); L. Johnson & D. Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989); M. Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 11 (1987) (on the correlation between hostile takeovers and junk-bond financing); R.B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: Sacred Space and Corporate Takeovers*, 80 U. TEX. L. REV. 261 (2001).

the communitarian movement.¹⁶⁴

Communitarians argue that corporations are institutions tied to all their components—including shareholders, debtholders, managers, employees and even local communities¹⁶⁵—by means of trust and mutual interdependence.¹⁶⁶ Therefore, they radically rebut the contractarian idea of

¹⁶⁴ In particular, these scholars charged the big profits realized through takeover activity with the accusation of being inefficient (and illegitimate) wealth transfers from weaker corporate components to shareholders. For example, Shleifer and Summers claimed that shareholders' gains can be explained as transfers of wealth from employees. See A. Shleifer & L.H. Summer, *Breach of Trust in Hostile Takeovers* in CORPORATE TAKEOVERS, CAUSES AND CONSEQUENCES 33 (eds. 1988). See also M.A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993); M.A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991). McDaniel, instead, focused on creditors (i.e., bondholders), arguing that they are the corporate actors that "pay" for shareholders' return in takeovers transactions. M.W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); M.W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988); M.W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991). On the negative effects of takeovers on bondholders, see L.E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990);

¹⁶⁵ The new communitarian vision of the corporate entity embraces also local communities, which can be harmed by profit seeking strategies as much as other non-shareholders constituents. Thus territorial communities in which the firm operates may suffer losses in terms of tax revenues and charitable contributions. Moreover, they may also find themselves saddled with costly public works projects that h become useless once a corporation moves away. See Millon, *supra* note 131, at 232-233; Millon, *Redefining Corporate Law*, *supra* note 162, at 235.

¹⁶⁶ On the importance of trustworthiness among corporate participants, see M.M.

the corporation as a contractual structure in which parties can freely bargain for their interests. For communitarians, the contract is an inadequate instrument to govern corporate relationships and guarantee protection of corporate participants.¹⁶⁷ In particular, employees and lower level managers would be the parties at greatest disadvantage, lacking both shareholders' economics means and their privileged access to corporate information as directors' principals.¹⁶⁸ The losses suffered by non-shareholder constituencies in bust-up takeovers would provide a clear example of these parties' inability to adequately protect themselves by contract.¹⁶⁹ Accordingly, communitarians claim that the proper role of corporate law is to consider and protect the interests of all corporate members. To achieve this

Blair & L.A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001); Mitchell, *Fairness and Trust in Corporate Law*, *supra* note 162.

¹⁶⁷ Some commentators argue that the communitarian or anti-contractarian theory of the firm is merely a modern version of the "old" concession theory of the corporation. These scholars reconnect the special public character of corporations advocated by communitarians to the state's sovereignty concession to corporations. From this perspective, state confirmation would still represent an essential element in order to legally effectuate a corporate structure. The result of such historical vision of corporations as entities emanating from state concession is that for anti-contractarians certain regulatory provisions are untouchable (i.e., cannot be waived or modified by private ordering). The most important among these provisions are directors' fiduciary duties to creditors. See A.E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995).

¹⁶⁸ See Brudney, *Corporate Governance*, *supra* note 162, at 1403.

¹⁶⁹ See Singer, *supra* note 162, at 618.

end, they advocate a corporate system for the large part comprised of mandatory rules,¹⁷⁰ rejecting the contractarian idea of gap-filling corporate rules. In other terms, communitarians conceive regulation as the only mechanism able of efficiently shaping corporate relationships.¹⁷¹

As a matter of fact, communitarians embrace an egalitarian and progressive view of society, which radically departs from the utilitarian

¹⁷⁰ The leading advocates of the mandatory nature of legal rules include Victor Brudney, Melvin Eisenberg and Jeffrey Gordon. Brudney, in particular, justifies the need for government intervention on the ground of “the institutionalized disparity in bargaining power between management and dispersed investors over the terms of their arrangement.” See Brudney, *Corporate Governance*, *supra* note 162, at 1444. Similarly, Eisenberg (while not necessary a communitarian) claims that corporate law is for the large part comprised of mandatory rules. See M.A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1462 (1989). Gordon is probably the strongest supporter of the mandatory nature of corporate law, suggesting that such rules “are one bulwark against opportunism....” See Gordon, *supra* note 162, at 1555, 1597-98. For a discussion of the mandatory nature of corporate law that puts at the center of the analysis the role of courts, see J. Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1619 (1989) (arguing that “what is most mandatory is not a particular rule, but rather the use of courts as an ex post dispute resolution mechanism to resolve those issues and contingencies that the inevitable incompleteness of the corporate contract leaves open.”)

¹⁷¹ The change in state anti-takeover regulation constitutes a clear example of the communitarians’ call for corporate law reforms. This regulation intervened to modify existing corporate law in order to take into better account the losses of non-shareholders constituencies and curb the effect of hostile takeovers on such corporate members. See Millon, *supra* note 131, at 233; D. Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 WASH. & LEE L. REV. 903, 905 (1988). See also *infra* notes 269-270 and accompanying text.

individualism of contractarians.¹⁷² They believe in a shared moral commitment among the members of a same community of interests, under which individual members enjoy rights and owe duties independently from any contractual boundary.¹⁷³ Government action is required to prevent deviant behaviors among the community's members. Hence, legal rules and institutions are the means to protect and enhance the freedom of the community's members rather than the instrument that constrains their freedom.¹⁷⁴

As within the contractarian theory, the role and duties of directors is at the core of the communitarian theory. Within this theory, directors are viewed as the fundamental instrument to balance distributional disparities among corporate participants. Accordingly, directors should exercise their authority over the corporation to maximize the interests of shareholders as much as those of employees, suppliers, consumers, local communities, and any other corporate constituency. This is the so-called *multi-fiduciary* or

¹⁷² For some insights on the political theory underlying communitarianism, see Cox, *supra* note 133, at 396-398; J.R. Wallach, *Liberals, Communitarians, and the Tasks of Political Theory*, 5 *POLITICAL THEORY* 568-611 (1987); R. RORTY, *CONSEQUENCES OF PRAGMATISM* (1982); R. Rorty, *Postmodernist Bourgeois Liberalism*, *J. PHIL.* 583 (1983); M. SANDEL, *LIBERALISM AND THE LIMITS OF JUSTICE*, (1982); M. Sandel, *Morality and the Liberal Idea*, *THE NEW REPUBLIC*, 7 May 1984, 15-17 (1984).

¹⁷³ Millon, *Contractarians, Communitarians*, *supra* note 162, at 1382.

¹⁷⁴ *Id.* at 1383 (“To communitarians, life chances should not depend entirely on accidents of birth and bargaining power: people are entitled to more out of life than what they can pay for.”).

entity model of corporate governance, under which directors' fiduciary duties are owed to all corporate participants.¹⁷⁵ This model requires directors to evaluate the effects of their decisions on each category of corporate participants, avoiding strategies that can negatively affect one category or the other.

It is thus unsurprising that communitarians reject the contractarian view of directors' fiduciary duties as default rules, defending the mandatory nature of such duties.¹⁷⁶ In their view, corporate law needs to regulate directors' fiduciary duties in order to assure full protection of non-shareholder interests. Hence, corporate actors cannot establish dominant

¹⁷⁵ See R.M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1419 (1993). It is important to emphasize, however, that not all communitarians agree with this paternalistic view of the corporate system. Instead, the communitarian movement involves at least other two variants. The first, and perhaps more important, is the variant centered on economic efficiency rather than egalitarianism. Under this variant, the maximization of overall corporate welfare rather than shareholder wealth is chosen because more efficient rather than more fair. See *infra* Part IV.2.1.2. The second, instead, is the "neo-republican" variant. This variant substitutes participatory political mechanisms to the egalitarian instance's institutional mechanisms. Among the theorists of neo-republicanism, see F. Michelman, *Law's Republic*, 97 YALE L.J. 1493 (1988); C.R. Sunstein, *Beyond the Republican Revival*, 97 YALE L.J. 1539 (1988). For a legal overview, see Cox, *supra* note 133, at 396-397, 402, 470-474.

¹⁷⁶ Among the studies that support this view of fiduciary duties, see A.G. Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 756, 760 (1978); D.M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375 (1988); M.A. Eisenberg, *supra* note 162, at 1462; S. FitzGibbon, *Fiduciary Relationship Are Not Contracts*, 82 MARQ. L. REV. 303 (1999).

categories of stakeholders or require directors to subordinate non-shareholders' interests to shareholders'. However, within this view, fiduciary duties also serve to protect shareholders' interests. This is because communitarians disregard the adequacy of the contractual instrument to mitigate not just conflicts among shareholders and other corporate participants, but also shareholders and directors. Finally, for communitarians fiduciary duties should address and balance the divergences of power, wealth and interests among all corporate participants, including both shareholders and non-shareholders.

IV. ECONOMIC OR IDEOLOGICAL PARADIGMS?

Part III has introduced the essential features that respectively characterize the contractarian and communitarian theories of the corporation and corporate fiduciary duties. Framing this debate in terms of *vertical* and *horizontal* corporate conflicts is useful to further the understanding of each theory's law and economics implications.¹⁷⁷ Vertical corporate conflicts arise from the position of directors as agents running the business enterprise on behalf of outside investors. Indeed, directors, as agents, may have incentives to pursue their own interests rather than the best interest of their investors.¹⁷⁸ Among others, they may shirk,¹⁷⁹ extract private benefits from control,¹⁸⁰ and entrench themselves.¹⁸¹ Economically, the common feature of these behaviors is that directors avoid taking costly actions that increase firm value—a

¹⁷⁷ See *supra* note 37 .

¹⁷⁸ See Jensen & Meckling, *supra* note 10, at 308.

¹⁷⁹ “*Shirking* is the term commonly used to define situations where the agent is not fully focused on pursuing the principal’s best interest—in the corporate context, on maximizing corporate profits.” See S. Sepe, *Making Sense of Executive Compensation*, 36 J. DEL. CORP. L. 136, 197, fn. 27 (2010).

¹⁸⁰ The extraction of private benefits can take several forms, including cash expropriation, perquisites’ consumption, the undertaking of projects that benefit the agent rather than the principal, and empire building (i.e., engaging in corporate expansion beyond what is rational). See A. Shleifer & R. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 742 (1997).

¹⁸¹ Entrenchment occurs when directors and managers “stay on the job even if they are no longer competent or qualified to run the firm” See *id.*, at 742-43.

problem generally labeled as *insufficient effort*.¹⁸² Viewed through this lens, the differences between the contractarian and communitarian positions are more formal than substantial. Contractarians identify in the shareholders the exclusive principal of directors. Instead, communitarians envision a model with multiple principals,¹⁸³ including investors in equity capital (i.e., shareholders), debt capital (i.e., debtholders), labor capital (i.e., workers), and all the other corporate constituencies. From a pragmatic perspective, however, this distinction is not that significant as concerns vertical conflicts, because the interests of outside investors are aligned when directors exert insufficient effort. As put by one commentator, “the concerns about managerial slack [i.e., insufficient effort] are shared to some degree by all parties who contribute to the enterprise.”¹⁸⁴ Accordingly, we can say that no

¹⁸² Economists broadly use the term *effort* to refer actions the agent takes to advance the principal’s interest. See, e.g., JOHN ROBERTS, *THE MODERN FIRM: ORGANIZATIONAL DESIGN FOR PERFORMANCE AND GROWTH* 126–27 (2004). From this perspective, an agent exerts effort when she does not extract private benefits because she gives up the monetary and non-monetary benefits that may arise therefrom.

¹⁸³ In the economics of information, a common agency problem arises when a single agent performs tasks on behalf of multiple principals who have divergent preferences. See B. D. Bernheim & M. D. Whinston, *Common Agency*, 54 *ECONOMETRICA* 923, 923–24 (1986). Consistent with this paradigm, in the modern corporation directors/managers act as agents—in the economic sense of the term—of multiple constituencies. On the one hand, they exercise delegated authority over the enterprise on behalf of the shareholders. On the other hand, in this position, they execute the non-shareholder constituencies contracts with the corporations. See Sepe, *supra* note 37, at 124–33 (arguing that the common agency model provide a better descriptive account of the modern public corporations than the classical principal-agent problem by capturing both vertical and horizontal conflicts of interest).

¹⁸⁴ G. G. Triantis & R. J. Daniels, *The Role of Debt in Interactive Corporate*

real disagreement exists between contractarians and communitarians as to the negative mandate of the duty loyalty, which is designed to prevent directors from engaging in self-interested conduct.

The real conflict between contractarians and communitarians arises, instead, about horizontal corporate conflicts, which result from the competing claims of the firm's outside investors. Indeed, shareholders and other corporate constituencies intrinsically have divergent corporate interests. Shareholders expect managers to maximize corporate profits, while other corporate constituencies are fundamentally interested in the repayment of their fixed claims.¹⁸⁵ For contractarians, however, the problem of horizontal corporate conflicts is negligible and, in any event, subordinated to that of vertical corporate conflicts. It is negligible to the extent that maximizing shareholder wealth (i.e., corporate profits) also benefits other corporate constituencies by making more likely that the firm will duly meet its repayment obligations. Further, it is subordinated because while a rule that requires directors to maximize shareholder wealth may engender negative externalities for other corporate constituencies, these constituencies can efficiently contract around these externalities. On the contrary for communitarians, such a rule gives directors incentives to act in favor of

Governance, 83 CALIF. L. REV. 1073, 1078 (1995). See also Mitchell, *supra* note 37, at 603 (“[F]iduciary rules meant to restrain vertical conflicts focus on the actions of the fiduciary rather than the interests of the beneficiary, with the correlative point that the identification of the beneficiary is relatively unimportant as long as it is clear that the fiduciary has no legitimate interest in the property entrusted to her.”)

¹⁸⁵ See Sepe, *supra* note 37, at 115 (2010).

shareholders and at the expense of other constituencies, with the contract being an inadequate instrument to protect the interest of non-shareholders. From this perspective, the debate between contractarians and communitarians can be more accurately described as a debate revolving around the positive mandate of the duty of loyalty, which cryptically requires directors to act “in the benefit of the corporation.” For contractarians this benefit always coincides with that of shareholders. On the contrary, for communitarians it coincides with the interest of the “corporate community” as a whole, which includes all the various corporate constituencies.

This Part expounds on the efficiency-based considerations underlying the scholarly and judicial answers that have been provided to the normative question of who should be the ultimate beneficiary of directors’ positive obligation of loyalty. To this end, this Part categorizes these answers under three different theoretical models (i) the contractarian-oriented *shareholder primacy model*, (ii) the communitarian *entity model*, and (iii) the more recent *team-production model*.¹⁸⁶ It is important to note that the effort of placing scholarly and judicial discussions of this issue on equal footing creates overlaps and chronological lags in some parts of the analysis. I maintain, however, that this is a little price to pay in light of the ultimate purpose of this analysis, which is to suggest that much of the modern debate around the puzzle of the beneficiary of directors’ fiduciary duties has been ideologically rather than economically driven.¹⁸⁷ A thorough analysis of the paradigms that

¹⁸⁶ See *supra* note 49.

¹⁸⁷ Cf. STOUT, *supra* note 6, at 3 (arguing that “shareholder value ideology is just

have been proposed to solve this puzzle reveals that contractarians and communitarians alike have chosen such paradigms more to suit ideological prejudices than develop an analytical theory of directors' fiduciary duties. A similar argument can be applied to the judicial decisions that have endorsed, whether directly or indirectly, one or the other of these approaches, with the ultimate result that the research of an answer to the fiduciary puzzle has failed to progress much.¹⁸⁸

1. The Shareholder Primacy Model

The principle that directors owe fiduciary duties to shareholders—commonly known as *shareholder primacy model* (or *rule*)—provides the historical paradigm of U.S. corporate fiduciary law.¹⁸⁹ As noted above, this

that—an ideology, not a legal requirement or a practical necessity of modern business life.”) While I share much of Stout’s criticism of the shareholder primacy model, I argue that she eventually falls in a similar ideological mistake in the elaboration of the team production theory of the corporation. *See infra* Part IV.3.

¹⁸⁸ *See* Krugman, *supra* note 6 (making a similar claim about economic ideologies in general in the pre- and post- financial crisis landscape).

¹⁸⁹ *See, e.g.,* Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993) (“Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers”); Gordon Smith, *supra* note 131, at 283 (“The shareholder primacy norm is considered fundamental to corporate law”); K.B. Davis, *Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain—A Survey of, and Commentary on, the U.S. Corporate Law*, 13 CAN.-U.S. L. J. 7, 8 (1988) (“The bedrock principle of U.S. corporate law remains that maximization of shareholder value is the polestar of managerial decisionmaking.”); Lipson, *supra* note 67, at 1214 (“The shareholder maximization norm is the dominant theoretical approach to directorial duties ...”); B.Black & R. Kraakman, *A Self-*

paradigm has later become axiomatic of the contractarian theory, which has re-conceptualized shareholder primacy from an economically grounded perspective.

Under the shareholder primacy model, the firm is conceived as a profit-making entity whose interest coincides with the shareholders'.¹⁹⁰ In economic terms, within this model pursuing shareholders' interest is the best proxy to increase aggregate social welfare. Hence, the only concern of directors should be to produce the maximum returns for the shareholders' corporate investments or—as stated in a famous decision—manage the

Enforcing Model of Corporate Law, 109 HARV. L. REV. 1911, 1921 (1996) ("The efficiency goal of maximizing the company's value to investors [is] the principal function of corporate law."); Millon, *Communitarians, Contractarians*, *supra* note 162, at 1374 ("[S] hareholder primacy has served as corporate law's governing norm for much of this century... [and] this governing norm heavily influences corporate decision making.").

¹⁹⁰ The uncontested opinion among corporate scholars is that directors owe fiduciaries duties to common shareholders, but not preferred shareholders. Courts do not apply fiduciary duties standards to protect preferred stockholders' rights, except in situations where the preferred shareholders' interests are threatened by corporate control transactions involving interested directors or a controlling stockholder. Hence, many commentators suggest that preferred stockholders "are not stockholders at all", but fixed claimants whose interests are exclusively regulated by explicit contracts. *See, e.g.*, L.E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443, 444 (1996); Mitchell, *supra* note 37, at 590-594; R.B. Robbins & B. Clark, *The Board's Fiduciary Duty to Preferred Stockholders*, 7 INSIGHTS 18 (1993); G.S. Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primary Norm*, 55 SMU. L. REV. 141 (2002); M.E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholder*, 21 DEL. J. CORP. L. 27, 38 (1996).

corporation's affair in order to get shareholders "until the last penny".¹⁹¹

1.1. The Shareholder Primacy Model in the Academic Debate

Several arguments have been advanced to justify shareholder primacy. However, three stand out as largely dominant: (i) the shareholder ownership argument, (ii) the residual claimant argument, and (iii) the contractual incompleteness argument. The following discussion illustrates each of these arguments in turn.

1.1.1. The Shareholder Ownership Argument

The traditional argument used to support shareholder primacy rests on the position of shareholders as firm "owners". This argument dates back to the turn of the century, when the large public corporation with dispersed ownership replaced the closely held corporation as the dominant U.S. business model.¹⁹² The separation of ownership from control was the primary consequence of this novel business model, with directors substituting shareholders in the management of corporate affairs. Harvard professors Adolph Berle and Gardiner Means famously articulated this view of the corporation in their 1932 masterpiece, *The Modern Corporation and Private Property*.¹⁹³ The necessary corollary of this view was that shareholders, as

¹⁹¹ See *Revlon*, *supra* note 234, at 182. See also *infra* Part IV.1.2.3.

¹⁹² See *supra* note 132 and accompanying text.

¹⁹³ See BERLE & MEANS, *supra* note 31. Although the argument of shareholder "ownership" is largely residual and mostly appearing in the popular press, the use of this argument is not infrequent at common law. See, e.g., *Koehler v. Black*, *supra* note 60; *Simons v. Cogan*, 549 A.2d 300 (Del. 1988); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998).

owners of the corporation, deserved legal protection against the risk of misbehavior by those in charge of managing it, the directors. That is, Berle and Means conceived the shareholder primacy norm as the response made available by law to the risk of expropriation of the shareholder-owners by opportunistic managers. Thus, within this analytical framework the function served by corporate fiduciary law is limited to reconciling decentralized property with centralized management, without any consideration of the potential horizontal conflicts that may arise among the various corporate participants.

Nobel laureate and Chicago school economist, Milton Friedman famously re-proposed the shareholder ownership argument in an article that appeared on the New York Times in 1970, observing that because shareholders are "the owners of the business", the only "social responsibility of a business is to increase its profits."¹⁹⁴ For Friedman, directors are nothing more than employees hired by shareholders-owners to the purpose of incrementing the value of shareholders' corporate investments. Therefore, directors should "conduct the business in accordance with [shareholders'] desires, which generally will be to make as much money as possible"¹⁹⁵

Both critics and supporters of the shareholder primacy rule, however, have challenged the shareholder ownership argument. For example, professor

¹⁹⁴ M. Nobel , *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32-33, 122-26.

¹⁹⁵ *Id.*

Lynn Stout—one of the proponents of the team production model of corporate law—¹⁹⁶ has criticized this explanation as “the worst argument for shareholders’ primacy”.¹⁹⁷ But even the “most frequent defender of the shareholder primacy norm”,¹⁹⁸ Stephen Bainbridge, has rebutted this argument. Indeed, commentators on both sides agree that the shareholder ownership argument is based on a misconception of corporate law or—to use Professor Bainbridge’s words—“what is now an outdated theory of the firm”.¹⁹⁹ Shareholders do not own the corporation. They do not exercise control over the corporate assets nor have any direct right on corporate earnings—two essential features of ownership.²⁰⁰ As the next paragraph will explain, shareholders are instead “residual corporate claimants”.

1.1.2. The Residual Claimant Argument

The argument that shareholders are residual claimants—introduced in the law and economics scholarship by Chicago Law School professors Frank

¹⁹⁶ See *infra* Part IV.3.

¹⁹⁷ See L.A. Stout, *Bad and Not-so-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190 (2002).

¹⁹⁸ Gordon Smith, *supra* note 131, at 281.

¹⁹⁹ See Bainbridge, *supra* note ____, at 1427.

²⁰⁰ See S.M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 172 (fn. 27) (1991). (“Legally, of course, the shareholders are not the “owners” of the corporation. They cannot pledge its assets or sell them, they cannot act for the corporation in business dealings, and they cannot hire and fire employees. Simply put, shareholders own stock, not the corporation.”)

Easterbrook and Daniel Fischel²⁰¹—is the standard contractarian justification for shareholder primacy. As observed by Easterbrook and Fischel, “[s]hareholders are residual claimants to the firm’s income ... [This means that] [t]he gain and losses from abnormally good or bad performance are the lot of shareholders, whose claims stand last in line”.²⁰² In other terms, shareholders’ payoff structure makes them intrinsically interested to overall firm performance. Instead, other corporate participants only have fixed claims on the corporate income stream and are, therefore, less interested in the outcome of corporate projects. Hence, because shareholders “receive most of the marginal gains and incur most of the marginal cost”²⁰³ from the corporate activity, they are in the best position to exercise discretion over corporate affairs.²⁰⁴ The structure of the modern corporation, however, prevents shareholders from exercising discretionary powers directly.²⁰⁵ This explains why the law attributes shareholders voting rights: to elect directors who will exercise corporate discretion on their behalf. From this perspective, fiduciary duties set the default contractual terms of the shareholder-director contracts, requiring directors to exercise delegated discretionary powers in the exclusive benefit of shareholders, as residual corporate claimants.

²⁰¹ EASTERBROOK & FISCHEL, *supra* note 38, at 36-39, 67-68.

²⁰² *Id.*, at 68.

²⁰³ F. Easterbrook & D. Fischel, *Voting in Corporate Law*, 26 J. L. ECON. 353, 403 (1983).

²⁰⁴ *Id.*

²⁰⁵ *See supra* Part III.1.1.1.

Further, the exclusive attribution of voting rights and fiduciary duties to shareholders serves as the means to ensure that directors will not deviate from the desirable decisional scheme. Indeed, giving shareholders the power to remove the board and bring liability actions against them provides directors with the right incentives to avoid self-interested conducts in order “to advance their own careers and avoid being ousted.”²⁰⁶

Therefore, the ultimate assumption underlying the residual claimant argument in favor of the shareholder primacy rule is that under this rule each corporate participant receives exactly what she has bargained for. On the one hand, shareholders receive the residual right to the firm’s income and, therefore, representation on the board of directors in order to monitor firm’s performance and ensure enforcement of their corporate contract. On the other hand, other corporate constituencies receive the right to fixed compensation and other obligations, as provided for by their individual contracts with the firm.²⁰⁷

1.1.3. The Contractual Incompleteness Argument

As the most influential explanation of the shareholder primacy norm,²⁰⁸ the residual claimants argument has also been the most criticized.

²⁰⁶ EASTERBROOK & FISCHER, *supra* note 38, at 68.

²⁰⁷ Cf. O. Williamson, *Corporate Finance and Corporate Governance*, 43 J. FIN. 567 (1988) (arguing that debt governance works mainly out of rules (i.e., specified contractual provisions), while equity provides for the exercise of discretion).

²⁰⁸ In *Ashman v. Miller* Justice Hamilton held: “Equity recognizes that stockholders are the proprietors of the corporate interest and are ultimately the only beneficiaries thereof.

Some commentators have challenged its descriptive and normative value,²⁰⁹ others have questioned its efficiency,²¹⁰ and still others have argued that the residual claimant argument is simply irrelevant.²¹¹ In particular, Yale Law School professor Jonathan Macey has argued that the residual claimant argument does not provide sufficient support for making shareholders the exclusive beneficiaries of fiduciary obligations.²¹² This is because shareholders are not the only corporate constituency interested in the corporate decision-making process. Instead, there are situations in which non-shareholders are as interested in the outcomes of corporate projects as

Those interests are in virtue of the law entrusted through the corporation to the directors and from that condition arises the trusteeship of the directors with the concomitant fiduciary relationship.” *See* *Ashman v. Miller*, 101 F.2d 85, 90-91 (6th Cir. 1939).

²⁰⁹ *See, e.g.*, Stout, *supra* note 97, at 1195, 1208 (suggesting that the residual claimant argument “treats shareholders' supposed status as sole residual claimants as a normative desideratum rather than as a positive description of the state of the world”); Green, *supra* note 175 (arguing that non-shareholders constituency statutes demonstrate both the descriptive and normative deficiency of the shareholder primacy rule).

²¹⁰ *See, e.g.*, Blair & Stout, *supra* note 49, at 287-289 (criticizing the suitability of the rule to promote overall welfare maximization); Crespi, *supra* note 49, at 143 (“[E]conomic efficiency would be enhanced if the locus of corporate officials' fiduciary duties was redefined as running to the corporation”).

²¹¹ *See, e.g.*, Gordon Smith, *supra* note 131 (considering the shareholder primacy norm irrelevant to corporate decision making in modern, publicly traded corporations but for takeover contexts).

²¹² J.R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991). For a detailed critic of Professor Macey's argument, see Wallman, *supra* note 200.

shareholders. This is the case of, for example, corporate decisions that risks jeopardizing the payment of non-shareholders' fixed claim.²¹³ Thus, the argument that shareholders, as the constituency that bears most of the

²¹³ To better illustrate this argument, Macey proposes the following asset substitution example. *See supra* note 9 and accompanying text. He considers corporate directors of a company with only two classes of claimants (i.e. shareholders and fixed claimants) who face a corporate decision among three projects:

- (i) Project A, which has a 50% chance of producing a payoff with a present value of \$1 million and a 50% chance of producing a payoff with a present value of \$5 million at the end of period one (Thus, the expected present value of Project A is \$3 million.);
- (ii) Project B, which has a 50% chance of a payoff with a present value of \$1 million, and a 50% chance of a payoff with a present value of \$6 million at the end of period one (Thus, Project B has an expected value of \$3.5 million.); and
- (iii) Project C, which has a 50% chance of producing a payoff with a present value of \$500,000, and a 50% chance of producing a payoff with a present value of \$10 million at the end of period one. (Thus, Project C has an expected value of \$5.25 million.).

He further poses that at the end of period one the company will owe the fixed claimants \$1 million. For the fixed claimants the choice between Project A and Project B will be irrelevant. This is because in both cases the company will be able to meet its obligations to them. But the fixed claimants' position changes "dramatically" in relation to Project C. In such a case, in fact, the fixed claimants run the risk that the company will not be able to pay back its debt. Therefore, the fixed claimants will not be indifferent to the potential directors' decision to pursue Project C. *Id.* at 29-31. As I will explain in more detail in Part V of this research, this kind of situation poses a serious challenge to any contractarian elaboration of fiduciary duties. In fact, the problem of asset substitution provides an example that challenges not just the residual claimant argument in favor of shareholder primacy—as Macey suggests. Instead, it also challenges Macey's own argument to support shareholder primacy. *See infra* Part V.3.

marginal costs of the corporate activity,²¹⁴ should be the sole beneficiaries of directors' duties is incomplete. As a matter of fact, such argument does not explain why other constituencies do not deserve the same kind of protection, at least when corporate decisions are potentially detrimental to their corporate interests.

Macey suggests that the ultimate reason for shareholder primacy consists on the greater difficulties (i.e., higher costs) implied by the shareholders' corporate contracting.²¹⁵ These difficulties make it technologically impossible for shareholders to achieve full contractual protection by contract. Instead, other corporate constituencies can effectively bargain for contractual protection, because of their more limited interest in the firm's economic performance.²¹⁶ Furthermore, non-shareholders can rely on judicial gap filling of their explicit corporate contracts. Instead, because

²¹⁴ On the link between ownership of the firm and the class of corporate participants that bear the highest costs of market contracting, see H. Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 278-79.

²¹⁵ Together with Geoffrey Miller, Macey further developed such an argument for shareholder primacy. Indeed, they have argued that "the aggregate value of fiduciary duties to any group within the firm diminishes as those rights are shared with other groups". See Macey & Miller, *supra* note 158, at 403.

²¹⁶ In particular, Macey argues that non-shareholders would be able to protect themselves "by retaining negative control over the firm's operations". In other words, non-shareholders would have the ability of negotiating contractual rights to veto potentially any directorial decision. The fact that this does not normally happen is explained by the unwillingness of such corporate actors to pay for it (for example through reduced salaries or lower interest rates). *Id.* at 36.

of the implicit nature of their corporate contract, shareholders cannot rely on judicial gap filling. On this view, the attribution to shareholders of directors' fiduciaries duties is the only available device to fill in the implied terms of the shareholders' contract. In the end, making shareholders the exclusive beneficiaries of directors' duties simply give them "a level of judicial protection commensurate with the nature of the firm's contractual obligations to them".²¹⁷

This view—which I dub as neo-contractarian because it moves past traditional contractarian positions—has the merit of pointing out the oversimplification underlying the classical residual claimant argument in favor of shareholder primacy. In the real world, there are many corporate situations that are of interest for other corporate constituencies as much as for shareholders. Nevertheless, the neo-contrarian explanation of shareholder primacy fails to consider that in many of these situations, the contract may be as inadequate an instrument to protect the interests' of other corporate constituencies as the shareholders'. After all, if one brings the incomplete contract approach to the extreme, no contract can foresee and specify all possible contingencies when a relationship is long-term—as corporate relationships are.

1.2. The Shareholder Primacy Model at Common Law

As noted above, while shareholder primacy has later emerged as paradigmatic of the contractarian instance, it has also historically dominated

²¹⁷ *Id.*, at 44.

American case law.²¹⁸ Some commentators observe that the shareholder primacy rule has been displayed at common law well before the 1830 Ohio Supreme Court's ruling in *Taylor v. Miami Exporting Co* in 1830,²¹⁹ which is commonly acknowledged as the first case endorsing such a rule.²²⁰

1.2.1. Early Decisions

As most of the subsequent early decisions on shareholder primacy, *Taylor v. Miami Exporting Co.* grounded the dominant position of shareholders on the existence of a trust relationship between directors, as

²¹⁸ See A.B.A. Section of Business Law, Committee on Corporate Law, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2255 (1990) [hereinafter ABA REPORT, *Other Constituencies Statutes*] ("With few exceptions, courts have consistently avowed the legal primacy of shareholder interests when management and directors make decisions.").

²¹⁹ *Taylor v. Miami Exporting Co.*, 5 Ohio 162 (1831).

²²⁰ For these commentators, contemporary judicial rulings and scholarly work, in addition to early corporate charters and incorporation statutes, provide evidence on the application of the principle that would later become known as "shareholder primacy" since early American corporate law. The treatment of dividends and the exclusive attribution of voting rights to shareholders should be read in this sense. Similarly, the characterization of the shareholder-director relationship as one of trust would necessarily entail a duty on the part of the directors to act to the exclusive benefit of shareholders. Yet, the strongest argument in this line is probably that concerning the shareholders' exclusive right to initiate a derivative action (i.e., an action on behalf and to the benefit of the corporation) against the company's directors. See, e.g., Gordon Smith, *supra* note 131, at 291-304. For an early account, see also J.S. DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 18-19* (1917).

trustees, and shareholders, as trustors.²²¹ In upholding a fiduciary claim brought against the directors of Miami Exporting Co. by a shareholder,²²² the Ohio Supreme Court stated that:

[a]ll corporations are trustees for the individuals of which they are composed, and those who act for the corporation and conduct its affairs, are trustees for the corporation and cannot appropriate the corporation funds to their individual advantage, to gratify their passions or to serve any other purposes than those for the general interest of the corporation and its creditors.²²³

The language of the court was even more explicitly in *Dodge v. Woolsey*,²²⁴ the first case in which the United States Supreme Court recognized the shareholder primacy rule. The Supreme Court stated that:

It is now no longer doubted, either in England or the United States, that courts of equity, in both, have a jurisdiction over corporations to restrain those who administer them from doing acts which would amount to a violation of charters, or to prevent any misapplication of

²²¹ See *supra* text accompanying notes 60-61 (discussing the “law-of-trust” origins of American corporate fiduciary law)

²²² The case involved a claim brought against the directors of the Miami Exporting Company by one of its shareholders. The directors were accused to have implemented an illegitimate transaction to the sole purpose of determining a certain outcome in the next election of the company’s board. See *Taylor*, *supra* note 219, at 162.

²²³ See *id.*, at 166.

²²⁴ See *Dodge v. Woolsey*, 59 U.S. (18 How.) 331 (1855).

their capitals or profits, which might result in lessening the dividends of stockholders, or the value of their shares²²⁵

From this brief analysis, it clearly emerges that early common law—similar to early scholarly arguments in support of the shareholder primacy norm²²⁶—exclusively focused on the vertical dimension of corporate conflicts (i.e., the conflict between directors and shareholders), without taking into account horizontal conflicts.

1.2.2. Dodge v. Ford

After the ruling of the Supreme Court in *Dodge v. Woolsey*, American courts began to steadily enforce the shareholder primacy rule. However, it is the 1919 decision of the Michigan Supreme Court in *Dodge v. Ford Motor Co.* (“*Dodge v. Ford*”) that is commonly recognized as the case that set the judicial paradigm of the rule “once and for all”.

Dodge v. Ford arose from a lawsuit brought against Ford’s board of directors by some minority shareholders (the Dodge brothers),²²⁷ who

²²⁵ *Id.*, at 341.

²²⁶ See *supra* Part IV.1.1.1.

²²⁷ See *Dodge v. Ford*, *supra* note 5. Among the many authors who acknowledge the axiomatic value of the ruling in *Dodge*, see, e.g., Bainbridge, *supra* note 189, at 1423 (“[O]ne rarely finds stronger judicial rhetoric than that used by the court in the now classic case of *Dodge v. Ford Motor Co.*”); Blair & Stout, *supra* note 49 at 301, (“The 1919 decision in *Dodge v. Ford Motor Co.* is one of the most frequently cited cases in support of the shareholder primacy view”); Gordon Smith, *supra* note 131, at 315 (“The most quoted (...) statement of the shareholder primacy norm is taken from *Dodge v. Ford Motor Co.*”).

challenged the board's refusal to pay out dividends despite the firm's high profits.²²⁸ Under the influence of Henry Ford—the company's controlling shareholder and board chairman²²⁹—the Ford's board had indeed decided to pursue a plan to expand the company's manufacturing operations. Among others, this plan entailed the withholding of dividend payments owed to the corporation's shareholders.²³⁰ Mr. Ford justified his expansion projects on the “humanitarian” ground of creating more jobs and benefiting consumers through less expensive cars.²³¹ In ruling about these events, the Supreme Court of Michigan established what was to become the most oft-cited judicial reference for the shareholder supremacy norm:²³²

²²⁸ At the time of the case, Ford Motor Company was a more than flourishing corporation, reasonably expecting a profit for the year of upwards \$60,000,000. *See Dodge v. Ford*, *supra* note 5, at 503.

²²⁹ *Id.*, at 504 (“Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor.”)

²³⁰ The expansion plan approved by the board provided for the enlargement of Ford factory and the construction of another giant manufacturing facility and iron smelting plant. *See id.*, at 503-504.

²³¹ The plaintiffs alleged that the proposed expansion plan was “inimical to the best interests of the company and its shareholders and that, in any event, the withholding of the special dividend they had asked for, was arbitrary action of the directors requiring judicial intervention.” The board replied that it had been the policy of the corporation for a considerable time to annually reduce the selling price of cars, and that the company had long planned an expansion of its manufacturing capacity for which it was necessary to retain profits. *See id.*, at 499.

²³² Some commentators, however, have proposed an antithetical reading of the

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.²³³

From an historical perspective, this passage of *Dodge v. Ford* perfectly fits the pioneering corporate era in which it occurred. In that era, the U.S. corporate system was still in a phase of relative expansion. This

ruling in *Dodge v. Ford*. They argue that Ford at the time was a closely held corporation, oppressed by the force of Mr. Ford. Thus, the court's ruling should be more accurately read as a statement on the conflict among shareholders themselves rather than the content of directorial duties. *See, e.g., Blair & Stout, supra* note 49, at 302 (“[T]he decision in *Dodge v. Ford Motor Co.* is most accurately construed as a statement about the special duties shareholders owe each other in closely held corporations, not about the relationship between shareholders and other stakeholders in a corporation.”); Gordon Smith, *supra* note 131, at 279 (“[T]he court thought it was merely deciding a dispute between majority and minority shareholders in a closely held corporation In short, *Dodge v. Ford Motor Co.* is best viewed as a minority oppression case.”).

²³³ *Id.* at 507. It is worth observing that the Supreme Court of Michigan denied to take into account whether the decision of the board to enlarge its business was “inimical to the best interests of the company and its shareholders” because of the protection afforded by the business judgment rule. However, the court imposed on Ford to pay out dividends to its shareholders, since there was no reason for withholding the profits not employed to expand the business. The courts interpreted the accumulation of such retained earnings as “a clear evidence of an arbitrary refusal to distribute funds that ought to have been distributed to the stockholders as dividends.” *See id.*, at 508-9.

commanded bright-line rules in favor of shareholders in order to incentivize more corporate investments and the development of a mature capitalistic system. Equating shareholder value with corporate value—as *Dodge v. Ford* did—was a shortcut to achieve this goal. Accordingly, any deviation from this equation was conceived as potentially jeopardizing the social goal of American capitalism.

1.2.3. Revlon

The modern case in support of the shareholder primacy rule is *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (“*Revlon*”)²³⁴—a takeover case. As discussed above, following the concerns raised by the spread of hostile takeovers of the 1980s, both corporate law scholarship and case law started to pay increased attention to non-shareholder constituencies.²³⁵ This “reform movement” gained vast popularity when several states enacted new statutes that allowed directors to take into account the interests of non-shareholder components in major business decisions—the so-called *non-shareholders constituency statutes*.²³⁶ Judicial rulings along the same line followed soon. For example, in *Unocal v. Mesa Petroleum Co.*,²³⁷ the Delaware Supreme

²³⁴ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986). On the link between the ruling of the court in *Revlon* and the shareholder primacy norm, see, e.g., R.F. Hartman, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1769 (1993).

²³⁵ See *supra* Part II.2.

²³⁶ See *infra* notes 265-66 and accompanying text.

²³⁷ See *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946, 955-56 (Del. 1985).

Court explicitly recognized the directors' power to take into account "the impact [of takeovers] on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)".²³⁸ This movement, however, was suddenly "frozen" by the 1986 ruling in *Revlon*, which held directors liable for adopting defensive takeover measures with the purpose of, among others, protecting the interests of certain creditors of the company.

To better grasp the Delaware Supreme Court's reasoning in *Revlon*, it seems useful to briefly outline the underlying facts. Pantry Pride, Inc. (the plaintiff) approached Revlon proposing to acquire the company. The Revlon board, however, rejected Pantry Pride's offer, suspecting that it would be financed by junk bonds and, therefore, result in the company's dissolution. In order to thwart Pantry Pride's efforts to acquire the company, the board also adopted several defensive measures. Among others, these measures included a share repurchase program and an exchange offer program. Under the latter program, existing Revlon shares were exchanged with newly issued notes that provided for anti-takeover covenants, such as covenants limiting Revlon's ability to incur additional debt, sell assets or issue dividends.²³⁹

²³⁸ *Id.*, at 955. See also *infra* Part IV.2.2.1 (discussing the Unocal decision in detail).

²³⁹ *Revlon*, *supra* note 234, at 176-177. In order to stop Pantry's original "junk bonds financing" plan, the Revlon's board first adopted a "Note Purchase Rights Plan", which enabled Revlon to buy out existing shareholders at a substantial premium upon some triggering events. Further, the board repurchased 10 million of the company outstanding

Pantry Pride, however, went on with the acquisition plan. It countered the board's actions with several offers—each revising the bidding price upward and conditional on the waiver of the notes' restrictive covenants.²⁴⁰ In response, the board began negotiations with Forstmann Little & Co. ("Forstmann"), rapidly reaching an agreement for a leveraged buyout by Forstmann. The original agreement provided for a share price of \$56 and, importantly, the waiver of the notes' restrictive covenants.²⁴¹ When this agreement was announced to the market, however, the value of the notes fell abruptly and rumors of reported threats of litigation by "irate noteholders" started to spread.²⁴² Moreover, Pantry Pride made a new, higher, offer of \$56.25 per share, publicly announcing that it would top any higher bid from competitors. At this point, the board rushed into closing the deal with Forstmann. The final agreement provided for the following conditions: (i) Forstmann agreed to pay a purchase price of \$57.25 per share;

shares exchanging for each share of common stock tendered one "Senior Subordinated Note", which contained significant poison-pill-like covenants.

²⁴⁰ See *id.*, at 177-178.

²⁴¹ The original agreement with Forstmann also provided for a "golden parachute" option in favor of the incumbent board, that is, a termination agreement that granted substantial bonuses to Revlon directors and the right to buy stock in the new company. Further it provided for Forstmann's obligation to pay off the debt incurred by Revlon through issuance of the Notes. See *id.*, at 178.

²⁴² *Id.* ("The Notes, which originally traded near par, around 100, dropped to 87.50 by October 8. One director later reported (at the October 12 meeting) a "deluge" of telephone calls from irate noteholders, and on October 10 the Wall Street Journal reported threats of litigation by these creditors.")

(ii) a cancellation fee of \$25 million, and (iii) an exclusive-dealing promise that prevented Revlon from negotiating with other bidders, including Pantry Pride. In exchange, Forstmann agreed to support the par value of the Revlon notes, which had faltered in the market, through an exchange of new notes.²⁴³

The comparative analysis of the economics of the Pantry Pride and Fortmann offers emerges as a fundamental aspect of the court's ruling.²⁴⁴ The court pointed out that while Forstmann's offer of \$ 57.25 per share was a dollar worthier than Pantry Pride's \$ 56.25 bid, Forstmann's proposal was to be discounted for the time required to give full execution to the complex agreement agreed upon between the parties.²⁴⁵ Furthermore, while Forstmann's funding of the purchase price was not readily available, Pantry Pride already had a commitment by its investment banker to raise the acquisition balance in rapid times. In this light, the only discriminating factor in favor of the Forstmann's offer was Forstmann's commitment to support the Revlon notes.²⁴⁶ This circumstance induced the Delaware Supreme Court to condemn the Revlon directors for breach of their fiduciaries duties,

²⁴³ *See id.* at 179.

²⁴⁴ *Id.*

²⁴⁵ *See id.* at 284.

²⁴⁶ In addition to directly benefit the noteholders, this circumstance indirectly benefitted the directors, by shielding them from potential liability charges coming from the irate noteholders. ("In reality, the Revlon board ended the auction in return for very little actual improvement in the final bid. The principal benefit went to the directors, who avoided personal liability to a class of creditors to whom the board owed no further duty under the circumstances."). *See id.*

remarking that:

[a] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.²⁴⁷

In economic terms, the court adopted a Pareto criterion, establishing that the interests of non-shareholder constituents can be taken into consideration only when directors' decisions are also beneficial to shareholders.²⁴⁸ Therefore, under *Revlon*, directors' decisions are conceived as the result of a constrained optimization problem, with shareholder value at any point in time representing the constraint. Under this constraint, directors are allowed to make decisions that increase non-shareholder value as long as shareholder value does not decrease.

Viewed through this lens, *Revlon* simply specified the limits of

²⁴⁷ *Id.*, at 182.

²⁴⁸ The conclusion of Justice Moore's opinion are very clear on the matter:

in granting an asset option lock-up to Forstmann, we must conclude that under all the circumstances the directors allowed considerations other than the maximization of shareholder profit to affect their judgment, and followed a course that ended the auction for *Revlon*, absent court intervention, to the ultimate detriment of its shareholders.

Id., at 185.

directors' discretionary power to consider other constituencies' interests, but it did not exclude this power.²⁴⁹ More specifically, Revlon established that when an auction among active bidders is in progress—in other words, when it is clear that the company is for sale—directors cannot take into consideration other interests but the shareholders'. Thus, the defensive strategy adopted by the Revlon board at the time of the initial Pantry Pride's offer was justified to protect the overall corporate interest to continuing Revlon as an independent entity. But after the board had made clear that the breakup of the company was inevitable (by negotiating with Forstmann),²⁵⁰ shareholder wealth maximization had become the only applicable standard. Indeed, as remarked by the court:

[t]he duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the

²⁴⁹ Blair and Stout, in particular, argue that Revlon establishes that the sole field of application of the shareholder primacy rule is “when a formerly publicly held corporation is about to become essentially a privately held firm”. See Blair & Stout, *supra* note 49, at 309. Similarly, Gordon Smith suggests that Revlon confined the value of shareholder primacy to takeover contexts. See Gordon Smith, *supra* note 131, at 280 (“The shareholder primacy norm serves a different function in the context of takeovers than it does in the context of ordinary business decisions. Because takeovers usually are a terminal event for shareholders of the target corporation, the shareholder primacy norm protects rights that otherwise might be lost forever.”)

²⁵⁰ *Revlon*, *supra* note 234, at 182. Indeed, by entering into negotiations with Forstmann, it was the board itself that recognized that the company was for sale.

best price for the stockholders at a sale of the company.²⁵¹

It is important to emphasize, however, that while the decision in *Revlon* is more economically grounded than prior decisions on the shareholder primacy rule, the fiduciary benchmark *Revlon* endorses might still lead to the exclusion of several Kaldor-Hicks efficient decisions. For example, this benchmark excludes the opportunity of any inter-temporal shareholder transfer (i.e., the pursuing of long-term rather than short-term maximization goals), without taking into consideration that these transfers might be desirable from a social welfare point of view.

1.2.4. Katz v. Oak Industries

The decision in *Revlon* came just three days after another major decision concerning shareholder primacy, *Katz v. Oak Industries*.²⁵² Oak Industries, the company in question, signed an acquisition and stock purchase agreement with Allied-Signal Inc. (“Allied”), which provided for the transfer of some business activities and a large fraction of Oak shares to Allied in exchange for a substantial cash infusion. Implementation of the Allied agreement was conditioned on the acceptance by 85 percent of Oak’s existing debtholders of a tender offer providing for the exchange of Oak’s outstanding debt securities into either cash or common stock. The payout under the tender offer was lower than the debt securities’ par value but higher than their current market value. Further, the tender offer was premised on the waiver of

²⁵¹ *Id.*

²⁵² See *Katz v. Oak Indus. Inc.*, 508 A.2d 873 (Del. Ch. 1986).

certain protective covenants included in the underlying indentures. Katz, one of Oak debtholders, sought to obtain a preliminary injunction to enjoin the consummation of the tender offer, contending that it constituted a “coercive device” that jeopardized the interests of debt securities holders.²⁵³

It is important to note that at the time of the acquisition agreement, Oak Industries was in serious financial difficulties, which made a major recapitalization vital to the prosecution of the business. Indeed, the corporation’s financial situation was perhaps the most important factual assumption at the basis of the court’s legal reasoning.²⁵⁴ In considering the conflict of interests between Oak shareholders and debtholders, Chancellor Allen, sitting the case, observed:

[t]his case does not involve the measurement of corporate or directorial conduct against that high standard of fidelity required of fiduciaries when they act with respect to the interests of the beneficiaries of their trust. Under our law—and the law generally—the relationship between a corporation and the holders of its debt

²⁵³ See *id.* at 875. Katz argued that the exchange offer “benefited the common stockholders at the expense of the debt securities holders, forced the exchange of the debt instruments at an unfair price, and forced the debt holders to consent to the elimination of certain protective covenants.” *Id.*, at 878.

²⁵⁴ See *id.*, at 877 (also pointing out that the required amendments to the indentures’ terms were essential to make Oak Industries able to finalize the purchase agreement and therefore obtain fresh cash).

securities, even convertible debt securities, is contractual in nature.²⁵⁵

The opinion of Chancellor Allen leaves no doubt on the identity of the beneficiaries of directors' fiduciary duties. Non-shareholders constituencies of the firm deserve no other rights than that provided for by the terms of their contractual agreements. Chancellor Allen went even further along these lines, observing:

[i]t is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so "at the expense" of others (...) does not for that reason constitute a breach of duty. It seems likely that corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders.²⁵⁶

Pursuant to *Katz v. Oak Industries*, the mandate of shareholder primacy may require directors to pursue shareholder wealth "at all costs" upon some circumstances—regardless of whether this may result in the undertaking of courses of actions that are detrimental to the interests of other corporate components. The survival of the corporation is one of those circumstances. That is, imposing losses on the debtholders may be justified

²⁵⁵ *Id.*, at 879.

²⁵⁶ *Id.*

when this is the only means to avoid a termination-threatening event or—to use the words of Chancellor Allen—represents the “last good chance to regain vitality for [the] enterprise”.²⁵⁷ On this view, no corporate benefit can arise for any involved party unless shareholders’ interests are not satisfied in the first place. In practice, this excludes any directorial discretion to implement actions that are not exclusively centered on shareholder wealth maximization. Analytically, directors’ decisions become an unconstrained optimization problem whose objective function is the maximization of shareholder wealth.

This approach, however, fails to fully address the efficiency-based concerns underlying the case. Indeed, the continuation of the corporation as a going-concern is not desirable per se, but only to extent that a company’s going-concern value is higher than its liquidation value.²⁵⁸ That is, Kaldor-Hicks considerations should guide the choice between continuation and liquidation of a business enterprise. Yet, not similar consideration appears in *Katz v. Oak Industries*. Further, similarly to *Dodge v. Ford*,²⁵⁹ this decision fails to address potential inter-temporal effects on corporate investments. One can reasonably expect that a rule that makes debtholders’ expropriation legitimate upon some circumstances may result in an increased cost of debt capital. This is because debtholders will rationally anticipate the detrimental

²⁵⁷ *Id.*

²⁵⁸ *See infra* Part V.2.

²⁵⁹ *See supra* Part IV.1.2.2.

effects of such a rule on their investment expectations and, therefore, demand ex-ante compensation for it. For these reasons, *Katz v. Oak Industries* ultimately emerges as another ideologically driven decision on the shareholder primacy.

2. The Entity Model

The entity model is the other mainstream theoretical approach to the analysis of the beneficiary of directors' fiduciary duties.²⁶⁰ This model rebuts the idea of shareholder primacy and proposes a vision of directors' duties as borne for the benefit of the corporate entity itself, that is, all corporate participants.

2.1. *The Entity Model in the Academic Debate*

The common feature of entity model theories is the identification of the corporate entity itself as the beneficiary of directors' fiduciary duties. However, the detailed articulation of this proposition differs—sometimes consistently—within the two variants of the model: namely, the egalitarian and the economically oriented variants.

²⁶⁰ See, e.g., M. M. Blair, *Stakeholders as Shareholders, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, 109 HARV. L. REV. 1150 (1996); W.S.W. Leung, *The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests*, 30 COLUM. J.L. & SOC. PROBS. 587 (1997); Millon, *Communitarians, Contractarians*, *supra* note 162; Millon, *Redefining Corporate Law*, *supra* note 162; MITCHELL, *PROGRESSIVE CORPORATE LAW*, *supra* note 162; Mitchell, *A Critical Look*, *supra* note 162.

2.1.1. The Egalitarian Variant

As hinted to above, the egalitarian variant of the entity model arises out of the takeover concerns of the eighties.²⁶¹ For scholars supporting this argument, the economic events of this period had the merit of bringing the interests of non-shareholders from the wings to center stage of academic, judicial, and regulatory discussion about fiduciary duties.²⁶² It was indeed in response to “the prompt asset liquidations and plant closings [and] dramatic employee layoffs”²⁶³ of the takeover era that both judicial decisions and state laws became more sensitive to such interests.

The defendants of the egalitarian variant see in the non-shareholder constituency statutes—enacted by most U.S. states in response to the distributive concerns raised by bust-up takeovers²⁶⁴—the means to move to

²⁶¹ See *supra* Part III.2.

²⁶² See Millon, *supra* note 131, at 241 (arguing that the hostile takeover era had the merit of fracturing “the complacently assumed unity of interest between the corporate entity and shareholders. As shareholders reaped unprecedented returns, lost jobs and other costly, highly publicized side effects focused attention on the fact that shareholder welfare did not necessarily imply corresponding benefits for nonshareholders.”).

²⁶³ *Id.*, at 234 (offering a detailed analysis of the effect of takeovers on various categories of “other constituencies” and, especially, employees.)

²⁶⁴ In 1983, Pennsylvania was the first state to adopt a corporate constituency statute, soon followed by about other thirty states with the notable exception of Delaware. See ARIZ. REV. STAT. ANN. § 10-1202(A) (1990); CONN. GEN. STAT. ANN. § 33-313(e) (1990); FLA. STAT. ANN. § 607.111 (9) (1990); GA. CODE ANN. § 14-2-202(5) (1989); HAW. REV. STAT. § 415- 35(b) (1990); IDAHO CODE § 30-1602 (1990); ILL. ANN. STAT. ch. 32, 8.85 (1990), as amended by Pub.Act 86-126, 1989 Ill.Legis.Serv. 1314; IND. CODE ANN. §

23-1-35-1(d)(f)(g) (1990), as amended by Pub.Law 277-1989 (approved Feb. 23, 1989); IOWA CODE ANN. § 490.1108 (1990); KY. REV. STAT. ANN. § 271B.12- 210(4) (1990); LA. REV. STAT. ANN. § 12:92(G) (1991); ME. REV. STAT. ANN. tit. 13-A, § 716 (1990); MASS. GEN. LAWS ANN. ch. 156B, § 65 (1990); MINN. STAT. ANN. § 302A.251(5) (1991); MISS. CODE ANN. § 79-4-8.30 (1990); MO. ANN. STAT. § 351.347 (1991); NEB. REV. STAT. § 21-2035(l) (1988); N.J. STAT. ANN. § 14A:6-14(4) (1990); N. M. STAT. ANN. § 53-11- 35(D) (1989); N.Y. BUS. CORP. LAW § 717(b) (1991); OHIO REV. CODE ANN. § 1701.59 (1989); OR. REV. STAT. § 60.357(5) (1989); PA. CONS. STAT. ANN. § § 511(d), (e), (g) & 1721(e), (f), (g) (1990); R.I. GEN. LAWS § 7-5.2-8 (1990); S.D. CODIFIED LAWS ANN. § 47-33-4 (1990); TENN. CODE ANN. § 48-35-204 (1988); WIS. STAT. ANN. § 180.305 (1990); WYO. STAT. § 17-16-830 (1989).

In most cases the statutes' provisions are introduced by the prefatory clause "[i]n considering the best interest of the corporation", followed by the recital of the expanded interests directors may consider in the corporate decision-making process. *See, e.g.*, ME. REV. STAT. ANN. tit. 13-A, § 716 (1990). Typically, the statement of interests includes one or more of the following provisions:

1. The directors may consider the interests of, or the effects of their action on, various non-stockholder constituencies.
2. These constituencies may include employees, customers, creditors, suppliers, and communities in which the corporation has facilities.
3. The directors may consider the national and state economies and other community and societal considerations. *See, e.g.*, OHIO REV. CODE ANN. § 1701.59.
4. The directors may consider the long-term as well as the short-term interests of the corporation and its shareholders. *See, e.g.*, FLA. STAT. ANN. § 607.111(9) (1990).
5. The directors may consider the possibility that the best interests of the corporation and its stockholders may best be served by remaining independent. *See, e.g.*, ARIZ. REV. STAT. ANN. § 10-1202(A) (1990).
6. The directors may consider any other pertinent factors. *See, e.g.*, ILL. ANN. STAT. ch. 32, 8.85 (1990), as amended by Pub. Act 86-126.
7. Officers may also be covered. *See, e.g.*, ME. REV. STAT. ANN. tit. 13-A,

the frontal assault of the shareholder primacy.²⁶⁵ From their perspective, the new statutes entail an *affirmative* and *negative* aspect.²⁶⁶ The first authorizes directors to consider non-shareholder interests in the corporate decision-making process, therefore “decentering” the role of shareholders within the firm.²⁶⁷ The negative aspect, instead, sets directors free from the exclusive

§ 716 (Supp. 1987).

²⁶⁵ See Millon, *Redefining Corporate Law*, supra note 162; Johnson, supra note 162; Mitchell, supra note 162; Wallman, supra note 200; E.W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992); P.J. Ryan, *Calculating the "Stakes" for Corporate Stakeholders as Part of Business Decision-Making*, 44 RUTGERS L. REV. 555 (1992). It is self-evident that the non-shareholder constituency statutes caused much upheaval among contractarians, who firmly among deplored their introduction. See S.M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971 (1992); M.E. DeBow and D. R. Lee, *Shareholders, Non-shareholders, and Corporate Law: Communitarians and Resource Allocation*, 18 Del. J. Corp. L. 393 (1993); W.J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385 (1990); J.J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991); Macey, *An Economic Analysis*, supra note 212; Macey & Miller, supra note 158; L. Ribstein, *Takeover Defenses and the Corporate Contract: Law Meets Economics*, 78 GEO. L.J. 71 (1989)

²⁶⁶ See, e.g., Millon, supra note 131, at 248.

²⁶⁷ See, e.g., Mitchell, supra note 37, at 584, 588-590; Millon, *Redefining Corporate Law*, supra note 162, at 225-226; D.W. Fessler, *Of Fishes, Frogs and Franchises and the Humble Suggestion of Misplaced Governmental Priorities*, 14 J. CORP. L. 111 (1988). In particular, David Millon has argued that “shareholders’ decentralization” should be intended as a new interpretation of the business judgement rule. Under the traditional view of directorial duties, directors fail to act in the best interest of the corporation—and are, therefore, liable for breach of duties—if they pursue interests different than shareholders’. Accordingly, “decentralizing” the role of shareholders means that directors should be shielded from liability if they “choose” non-shareholder interests over shareholders’

duty of maximizing shareholders' wealth. In fact, in a few cases, the statutes even give directors discretionary power to decide whether considering shareholders' interest at all.²⁶⁸

Nonetheless, non-shareholder constituency statutes are still far away from the implementation of the multi-fiduciary model of directors' fiduciary duties advocated by communitarian-egalitarians. Indeed, the statutes merely "consent" directors to consider non-shareholders' interests.²⁶⁹ For egalitarians, the lack of a mandatory provision requiring directors to pursue non-shareholders' interests exposes non-shareholders to the risk that directors will simply continue to only pursue shareholders' interests.²⁷⁰ They also

²⁶⁸ See, e.g., ILL. ANN. STAT. ch. 32, 8.85, as amended by Pub. Act 86-126; MO. ANN. STAT. § 351.347; TENN. CODE ANN. § 48-35-204 (1988). However, "it seems highly unlikely that these legislatures intended actually to exclude shareholder interests from the realm of legitimate management discretion; these would no doubt be included among unspecified "pertinent factors" or be subsumed within the reference to the interests of the corporate entity." See Millon, *supra* note 131, at 244. In this respect, it seems more relevant to observe that Connecticut's statute once read that directors "shall consider" non-shareholder interests. This provision, however, was amended in 2010 to read "may consider." CONN. GEN. STAT. ANN. § 33-756 (West 2010). Thus Connecticut has also joined the largely majoritarian position among state legislators of making the consideration of shareholders' interests mandatory, as opposed to discretionary consideration of non-shareholders' interests. See, e.g., OHIO REV. CODE ANN. § 1701.59 (Baldwin Supp 1989).

²⁶⁹ The non-shareholder constituency statutes do not provide any active role for non-shareholders in the corporate governance of the firm, nor they attribute them voting rights or give non-shareholders any means to make directors accountable to them. See Millon, *supra* note 131, at 244.

²⁷⁰ Executive compensation schemes, capital market pressures, competition among corporations for debt financing, product (or service) market competition and other substantial

suggest, however, that giving the new statutes “serious interpretation” can help to reduce this risk.²⁷¹ The several communitarian proposals that have attempted to articulate the content of this “serious interpretation” of the statutes can be summarized by the following tenets:

(i) directors should not privilege short-term shareholders’ gains at expense of legitimate non-shareholders’ expectations;²⁷²

(ii) directors should pursue wealth maximization strategies that balance shareholders’ interests and non-shareholders’ interests;²⁷³ and

(iii) directors should pay the just tribute to the legitimate expectations of non-shareholder constituencies when the termination of existing relationships is necessary to serve the best interest of the corporation.²⁷⁴

incentives would, on the contrary, prevent directors to sacrifice shareholders’ interests in favor of non-shareholders. See Millon, *Redefining Corporate Law*, supra note 162, at 260-264.

²⁷¹ *Id.* at 265.

²⁷² In this respect, Lawrence Michell proposes a model that confers to non-shareholders the right to challenge corporate actions that allegedly injured them. Non-shareholders would have the burden of proving the damage caused by such actions. If they are successful, the burden should then shift on the board to show that such an action was undertaken in pursuit of a legitimate corporate purpose. See Mitchell, supra note 37, at 635-636.

²⁷³ See, e.g., Millon, supra note 131, at 267-270.

²⁷⁴ See, e.g., Green, supra note 175; MITCHELL, PROGRESSIVE CORPORATE LAW, supra note 162; Mitchell, *A Critical Look*, supra note 162.

As a matter of fact, these normative results seem based more on a common sense of justice than an efficiency rationale. It is thus unsurprising that the egalitarian variant of the entity model has been largely criticized—suggestively, by both contractarians and economically oriented communitarians. The latter have mostly lamented the lack of efficiency-considerations underpinning the model, which undermines its scientific rigor. Contractarians, instead, have advanced a more radical argument, which equally applies to the egalitarian and the economic-oriented variant of the entity model. This is the so-called *too many masters* argument: requiring directors to consider non-shareholder interests in corporate decision-making would produce an ungovernable chaos, because directors should seek to balance too many and too different interests.²⁷⁵ Both these arguments, however, seem lacking. The first because the same criticism economic oriented communitarians move to egalitarians can be raised, as we shall see,

²⁷⁵ The American Bar Association has expressed such a concern very clearly in its report on corporate constituency statute:

The confusion of directors in trying to comply with such statutes, if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.

ABA REPORT, *Other Constituencies Statutes*, *supra* note 218, at 2269.

against their own elaborations of the directors' duty of loyalty.²⁷⁶ And the too many masters arguments because it is overstated, especially if confronted with modern corporations' multilayered capital structures, which counts not only different classes of stakeholders, but also shareholders.²⁷⁷ Denying consideration of other constituencies' interests on the ground that it would make the life of corporate directors "too complicated" is out of touch with the actuality of corporate life.

A better criticism to the egalitarian variant of the entity model is the one suggesting that such a model would risk making directors' substantially unaccountable, both as concerns vertical and horizontal corporate conflicts. This is because the displacement of shareholders from their institutional monitoring position would leave directors free to act with unfettered discretion.²⁷⁸ This, on the one hand, would increase the risk of directors' opportunism. On the other hand, it could also potentially exacerbate

²⁷⁶ See *infra* Part IV.2.1.2.

²⁷⁷ See, e.g., Macey & Miller, *supra* note 158, at 413.

²⁷⁸ *Id.*, at 412. See also ABA REPORT, *Other Constituencies Statutes*, *supra* note 218, at 2270. It is suggestive to observe that both these studies quote the work of Robert Clark on the matter:

[a] single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests Assuming shareholders have some control mechanisms, better monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do and do it efficiently".

R.C. CLARK, CORPORATE LAW 20 (1986).

horizontal corporate conflicts, because a more conspicuous number of corporate constituencies would attempt to have their rights enforced through judicial intervention under the egalitarian model.²⁷⁹ From an information perspective, such a model would inefficiently shift monitoring of directors' conduct from shareholders to less informed third parties, i.e., courts.

2.1.2. The Economic Variant

Under the economic variant of the entity model the concept of “benefit of the corporation” is interpreted as requiring directors to maximize overall corporate value. Importantly, this view departs from both the shareholder primacy norm, which requires directors to exclusively maximize shareholder wealth, and the egalitarian variant of the entity model, under which sociological and public policy implications provide the justification for requiring directors to act in the interest of all corporate participants.

Thomas Smith has clearly articulated the economic variant paradigm in an article published in the *Michigan Law Review* in 1999.²⁸⁰ The starting point of Smith's “neo-traditional interpretation” of directors' fiduciary—as he dubbed his theory—is that shareholders have been misunderstood as a

²⁷⁹ See, e.g., ABA REPORT, *Other Constituencies Statutes*, *supra* note 218, at 2270 (“If directors have, or may have, recognized legal duties to other constituencies, perhaps a new class or classes of plaintiffs will have access to the courts to redress perceived breaches of those duties or to challenge directors' failures to take various competing interests into account.”)

²⁸⁰ See T.A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 216-217 (1999).

“natural economic component” of the corporation, rather than a legal category created by corporate law.²⁸¹ Shareholders have erroneously been reified as a separate and independent class of economic actors.²⁸² Instead—as made clear by the modern financial canon and, in particular, the Capital Assets Pricing Model (“CAPM”)²⁸³—shareholders are “rational investors” that diversify their investment risk among all classes of capital assets,

²⁸¹ *Id.*, at 226. D.J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996) (suggesting that shareholders are a “legal fiction”); Wallman, *supra* note 200, at 173-174 (deconstructing the monolithic image of shareholders through a analysis of the differences between long-term and short-term shareholders, and undiversified and diversified shareholders)

²⁸² *Id.*, at 226-227, 236. (“Shareholders as a separate class, the Berle and Means “owners,” represent a nostalgic longing for a political economy that never existed.”)

²⁸³ The capital asset pricing model (CAPM) considers a specific corporate risk irrelevant to the determination of firm value because investors can eliminate that risk by diversifying their portfolios, that is, by investing in different types of capital assets. The only risk that matters, therefore, is the volatility of the firm as a part of the market as a whole, i.e. the systematic risk. See J. Lintner, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budget*, 47 REV. ECON. & STAT. 13 (1965); W.F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk*, 19 J. FIN. 425 (1964). For a law and economics account of these issues, see R.J. GILSON & B.S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 101 (2D ED. 1995); W. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U.L.Q. 1 (1987); H.T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277 (1990); H.T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1498 & n.247 (1993); L.A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475 (1997).

including both corporate stocks and bonds.²⁸⁴

From this observation, Smith moves to the deconstruction of the shareholder primacy rule as advocated by contractarians. While his basic argument is based on the hypothetical-bargaining approach, it challenges the idea that the shareholder primacy norm obtains as “the right solution” of this approach. This is because rational investors would never agree to a rule that allowed directors to make a decision that decreases the profitability of part of their portfolio (i.e., debt claims) by more than it enhances the value of another class of capital asset they hold (i.e., stock). Instead, they would choose a rule instructing directors to make decisions that maximize the overall value of their diversified portfolios.²⁸⁵

²⁸⁴ See Smith, *supra* note 280, at 239-242 (“[E]very rational investor holds the same portfolio of risky assets: each risky asset portfolio is a bigger or smaller slice of the same pie. But, bigger or smaller, each slice has the same ingredients and has them in the same proportions as every other slice and as the pie as a whole.”) *Id.*, at 238. From this basic consideration it follows that rational investors are not divided into shareholders and bondholders, or any other layer of the corporate entity; they are investors whose risky asset portfolios are identical but for their size. See also T.A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1 (1997).

²⁸⁵ See *supra* note 280, at 217. Smith adduces a very clear example to underline the difference between shareholders’ wealth maximization and corporate value maximization. He assumes that the directors of a certain corporation (XYZ corporation), with a net value of \$20 million and \$15 million liabilities, face a choice regarding the undertaking of a risky corporate project. Such corporate investment requires an outlay of \$ 10 million, and has a 10% probability of paying off at \$200 million, but also a 90% probability of generating losses of \$20 million, i.e. losses equal to the whole net value of the company. Hence, the expected value of the investment is only \$2 million and, net of the \$10 million outlay, it has

While Smith adopts a contractarian counterargument, his theory clearly falls within the entity model of fiduciary duties. Smith's efficient norm for corporate law differs from the shareholder primacy rule not only in substance—refusing such a rule as an inefficient gap-filler—but also in form. Under his theory, the corporate entity is the ultimate beneficiary of directors' duties, meaning that directors are required to maximize the value of the sum of all the financial claims against the firm.²⁸⁶ From this perspective the entity model assumes a new economic meaning: the corporate entity is the beneficiary of directors' duties because the duty to maximize overall corporate value needs an abstract collective entity capable of standing as object of the duty.

In economic terms, Smith's neo-traditional interpretation clearly endorses a Kaldor-Hicks efficiency criterion for administering directors' fiduciary duties. However, he does not address the important issue of how

a value of negative \$8 million. Put simply, it is a bad investment. Yet, managers bound to a duty of maximizing shareholder wealth would be obliged to pursue such investment. As a matter of fact, the investment would not be so bad for shareholders; whereas it paid off at \$200 million, they would get all of that, while if thing went wrong, they would lose only their investment in equity of XYZ corporation, i.e. \$5 million. However, the perspective radically changes if we consider shareholders as rational investors; in such a case, they would also have to consider the eventuality that if the investment goes wrong they could lose the whole of their investment in equity. Rational investor would not choose to pursue such an investment because the reduction of debt value that it would entails (the debt-holders expected losses of \$13,5 million) would not be outweighed by the increase in equity value (the shareholders total expected value of \$6,5 million). *Id.*

²⁸⁶ *Id.* at 246.

this criterion should be operationalized. Under his proposal, the content of fiduciary duties merely is a function of a corporation's capital structure. While plausible in theory, this approach may present serious feasibility issues. Consider the following hypothetical. There is a society with two corporations: X and Y. Each corporation only has two outstanding financial claims: equity and debt. However, while corporation X is funded by 90% equity and 10% debt, corporation Y has the opposite capital structure (i.e., 90% debt and 10% equity). Pursuant to Smith's proposal, the directors of corporation X should give more weight to strategies that maximize equity value. Instead, the directors of corporation Y should act in exactly the opposite way, giving more weight to strategies that maximize debt value. But if investors anticipate these strategies, they could have incentives to concentrate all their wealth in just one corporation to avoid the risk of ex-post wealth expropriations. At the extreme, this could lead to the paradoxical result of a world without diversified capital structures.

2.2. The Entity Model at Common Law

The post-takeover era did not just involve the enactment of non-shareholder constituency statutes and the rise of the communitarian theory. It also marked an important change in judicial trends. Motivated by new awareness about the negative externalities raised by the principle of shareholder wealth maximization, courts began to pay attention to corporate constituencies other than shareholders.

2.2.1. Unocal

The landmark ruling on the new communitarian-oriented approach of U.S. courts is *Unocal Corp. v. Mesa Petroleum Co.* (“Unocal”)²⁸⁷— still a takeover case involving a dispute over directors’ ability to enforce defensive strategies.

It is worth briefly summarizing the factual background of the case. Mesa Petroleum, the owner of 13% of Unocal’s stock, declared a two-tier tender offer to acquire control of Unocal.²⁸⁸ The Unocal board, however, rejected the offer, fearing that it was in fact a squeeze-out attempt sustained by junk bond financing. At the same time, the board implemented a defensive strategy, advancing an exchange offer to Unocal’s shareholders with the exclusion of Mesa Petroleum.²⁸⁹ The justification for such a course of action was that the board’s intent was indeed to defeat Mesa Petroleum’s “junk-bond offer.” Moreover, extending the exchange offer to Mesa Petroleum would have meant to finance Mesa Petroleum’s squeeze-out attempt.²⁹⁰

²⁸⁷ See *Unocal*, *supra* note 237.

²⁸⁸ The terms of Mesa Petroleum’s offer provided for (i) a front-end cash offer of \$54 per share for the 37 % of Unocal stock plus (ii) a back-end offer to exchange securities with the remaining Unocal shares. *See id.*

²⁸⁹ Specifically, the board’s resolution established that in case of success of the Mesa cash front offer for the 37% of Unocal stock, the company would have bought back from its shareholders the remaining 49% for an exchange of debt securities having an aggregate par value of \$72 per share. *See id.*, at 951.

²⁹⁰ The board alleged that extending the offer to Mesa Petroleum would have defeated their intent because “under the proration aspect of the exchange offer (49%) every Mesa share accepted by Unocal would displace one held by another stockholder.” *Id.*

Consequently Mesa sued the board of directors, contending that the discriminatory exchange offer violated the fiduciary duties the board owed to Mesa as a Unocal shareholder.

In addressing this claim, the court articulated a modified version of the business judgment rule for reviewing the board's defensive plan. The court held that:

If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of non-consummation, and the quality of securities being offered in the exchange.²⁹¹

This passage of the ruling has been interpreted as acknowledging the power of directors to justify anti-takeover defensive measures based on the protection of non-shareholders' interests.²⁹² Stretching this interpretation,

²⁹¹ *Id.* at 955.

²⁹² Revlon itself acknowledged the "Unocal's standard", although the court added that to consider nonshareholders' interests "there must be some rationally related benefits accruing to the stockholders." *See Revlon, supra* note 123, at 176. In this respect, it seems

communitarians have argued that *Unocal* is a turning point in the judicial elaboration of corporate fiduciary duties. In their view, *Unocal* displaces the primacy of shareholders' interests in favor of a corporate model that also encompasses the interests of other constituencies.²⁹³

Once contextualized within the specific circumstances of the case, however, the underlying economic rationale of *Unocal* seems less clear. Read in its entirety, the above passage seems more directed to enable directors to take action that protect minority shareholders from grossly inadequate takeover offers, such as the Mesa Petroleum's junk bond offer. The court clearly states this in other passage of the ruling, observing that when "a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders".²⁹⁴ In this light, the court's decision enforces more a criterion of overall welfare maximization than any egalitarian instance.

2.2.2. *Paramount v. Time*

The other pivotal case on the judicial application of the entity model

difficult to deny that the Delaware Supreme Court's intention in *Revlon* was to contain the "revolutionary" effect of *Unocal* and reinstate shareholder primacy.

²⁹³ A few courts had previously credited non-shareholders' interests, but in the limited context of charitable contribution. *See, e.g.,* L. Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 14 J. CORP. L. 35, 43 (1988)

²⁹⁴ *See Unocal*, supra note 237, at 954.

is *Paramount v. Time*.²⁹⁵ Paramount sued Time's directors alleging that they had prevented the company's shareholders from accepting Paramount's substantial tender offer at the sole scope of preserving their role within the firm.²⁹⁶

The essential facts of the case are as follows. On March 1989, Time had entered into a merger agreement with Warner Communications Inc. ("Warner") to the purpose of enhancing its media video industry and achieving global dimensions.²⁹⁷ Since the beginning of the strategic planning, Time board of directors committed to maintain Time as an independent enterprise and to preserve "Time culture"—a factor that will play a critical

²⁹⁵ See *Paramount Communications, Inc. v. Time, Inc.*, Civil Action nos. 10866, 1989 Del. Ch. LEXIS 77 (Del. Ch. July 1989), aff'd 571 A.2d 1140 (Del. 1989). For an exhaustive review of the case, see, e.g., Johnson & Millon, *The Case Beyond Time*, *supra* note 162; T.S. Norwitz, "The Metaphysics of Time": A Radical Corporate Vision, 46 BUS. LAW. 377 (1991).

²⁹⁶ As clearly stated by Chancellor Allen, the plaintiff alleged that "[t]he board of Time is doing this, it is urged, not for any legitimate reason, but because it prefers that transaction [the merger with Warner] which secures and entrenches the power of those in whose hands *management of the corporation has been placed*." *Paramount v. Time*, at 6.

²⁹⁷ The original merger agreement provided for, among others, the consolidation of Warner into a wholly-owned Time subsidiary (TW Sub Inc.), the conversion of Warner common stock into common stock of Time Incorporated, and the change of the name "Time" into "Time-Warner". It further provided for some restrictive measures, including a share exchange agreement that gave each party the option to trigger an exchange of shares (i.e., a put option to sell 11.1% of Time shares to Warner and a reciprocal put option to sell 9.4% of Warner share to Time) should the merger have failed. Finally, Time was contractually obliged to refrain from entering enter into any takeover negotiations with other bidders prior to the closing of the merger. See *id.*, at 26-30.

role in the final outcome of the court's decision.²⁹⁸ Before Time shareholders approved the merger,²⁹⁹ Paramount made an offer to purchase all Time's shares at a greater premium than that accruing to the shareholders under the agreement with Warner.³⁰⁰ Time's board of directors, however, rejected Warner's tender offer on the ground that the company was not for sale and that the ongoing transaction with Warner was far more appealing.³⁰¹ Further,

²⁹⁸ The court referred to "Time culture" several times in its decision, observing that
Neither the goal of establishing a vertically integrated entertainment organization, nor the goal of becoming a more global enterprise, was a transcendent aim of Time management or its board. More important to both, apparently, has been a desire to maintain an independent Time Incorporated that reflected a continuation of what management and the board regarded as distinctive and important 'Time culture.' This culture appears in part to be pride in the history of the firm—notably Time Magazine and its role in American life—and in part a managerial philosophy and distinctive structure that is intended to protect journalistic integrity from pressures from the business side of the enterprise.”

Id., at 13.

²⁹⁹ While the original merger only required the affirmative vote of a majority of Warner's shareholders under Delaware law (since only Warner's stock was to be converted in the new entity's stock), the transaction still required the approval of Time's shareholders pursuant to New York Stock Exchange rules. *See id.*, at 27.

³⁰⁰ Paramount's offer, which was conditioned on the termination of the Time-Warner merger agreement and related restrictive measures (first of all, the termination of the share exchange agreement), ranked at \$ 175 per share cash. *Id.*

³⁰¹ *See id.*, at 34 (observing that the Time board justified its refusal based on: "(1) a reasonable belief that the \$ 175 per share offer was inadequate if Time were to be sold, and (2) a reasonable belief that if Time were not to be sold, which was the board's determination, then Warner was a far more appealing partner with whom to have ongoing business

after refusing Paramount's offer, the board approved a resolution to restructure the agreement with Warner so that shareholders' approval was no longer required to finalize the deal.³⁰² Paramount countered with a higher offer, which was again refused by Time's directors. Finally, Paramount sued the board and sought preliminary injunction to prevent Time from carry on the merger with Warner, alleging that the board's strategy was only finalized to the preservation of their control position.

Chancellor Allen, sitting the case, framed the matter at hand as hinging on whether directors of a company could accept less current value in the hope of greater value in the future.³⁰³ Put differently, the normative

consolidation than was Paramount.”

³⁰² The board resolved to a restructuring of the deal with Warner, which provided for a cash acquisition by Time of a majority stake in Warner and was to be followed by a second-step merger. The overall effect of these measures was to exclude the need for shareholders' approval of the transaction. *See id.*

³⁰³ *See id.*, at 54 (“This is the heart of the matter: the board chose less current value in the hope (...) that greater value would make that implicit sacrifice beneficial in the future”). It is worth observing that Chancellor Allen was not new to this order of considerations. In *TW Services, Inc. v. SWT Acquisition Corp.* (“*TW Services*”), a takeover case that preceded *Paramount v. Time* of a few months, he had made the following observations about the directors' duty to act in the best interest of “the corporation and its shareholders”:

The knowledgeable reader will recognize that this particular phrase masks the most fundamental issue: to what interest does the board look in resolving conflicts between interests in the corporation that may be characterized as 'shareholder long-term interests' or 'corporate entity interests' or 'multi- constituency interests' on the one hand, and interests that may be characterized as 'shareholder short term

question underlying *Paramount v. Time* was whether directors could depart from the rule of short-term wealth maximization in favor of the long-term interest of the corporation.³⁰⁴ Chancellor Allen gave a positive answer to this question through a three-step analysis. First, he reinterpreted the decision in *Revlon*,³⁰⁵ holding that directors have no duty to maximize current shares' value when the company is not for sale or under any other "Revlon mode" (i.e., a situation entailing a change in the company's control).³⁰⁶ Hence, Time's directors had not breached their fiduciaries duties to shareholders under the Revlon standard, because Time was not for sale.³⁰⁷ Second,

interests' or 'current share value interests' on the other? [W]hen, if ever, will a board's duty to 'the corporation and its shareholders' require it to abandon concerns for 'long-term' values (and other constituencies) and enter a current share value maximizing mode?"

TW Services, Inc. v. SWT Acquisition Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94334, 92178 fn.5.(Del. Ch. Mar. 2, 1989). See also T.L.Hazen, *The Short-Term/Long-Term Dichotomy And Investment Theory: Implications For Securities Market Regulation and For Corporate Law*, 70 N.V.L. Rev. 137 (1991).

³⁰⁴ It is important to observe that the court excluded any bad faith on the side of Time's directors. (" ... there is no persuasive evidence that the board of Time has a corrupt or venal motivation in electing to continue with its long-term plan") See *id.*, at 88.

³⁰⁵ See *Revlon*, *supra* note 234.

³⁰⁶ See *id.*, at 58. (quoting, among other decisions, *Mills Acquisition*, *supra* note 101; *Ivanhoe v. Newmont*, *supra* note ___; *TW Services*, *supra* note --). In this respect, Chancellor Allen embraced the reading of *Revlon* advocated by entity model advocated, limiting the application of the shareholders primacy rule to "Revlon mode" cases, i.e., cases involving a proper sale of the company or a "sale" taking the form of an active auction, a management buyout, or a 'restructuring'. *Id.*, at 59-60.

³⁰⁷ Chancellor Allen fully embraced the defendants' position that they had never

Chancellor Allen went on to re-consider the Unocal standard,³⁰⁸ giving it broad interpretation. He held that the actions of the Time board were consistent with a long-standing strategic plan. Therefore, such actions were to be interpreted not as a control device but rather a manifestation of the board's willingness to manage the corporation for the long-term profit.³⁰⁹ Hence, the implementation of that plan was fully consistent with the Unocal standard which empowered directors to consider "other values" (i.e., interests other than shareholders') in corporate decision-making.³¹⁰ Third, although Chancellor Allen never explicitly addressed the issue of the "other values"

intended to enter into a sale of the company:

I cannot conclude, however, that the initial merger agreement contemplates a change in control of Time. I am entirely persuaded of the soundness of the view that it is irrelevant for purposes of making such determination that 62% of Time-Warner stock would have been held by former Warner shareholders. If the appropriate inquiry is whether a change in control is contemplated, the answer must be sought in the specific circumstances surrounding the transaction. (...) where, as here, the shares of both constituent corporations are widely held, corporate control can be expected to remain unaffected by a stock for stock merger. This in my judgment was the situation with respect to the original merger agreement. When the specifics of that situation are reviewed, it is seen that, (...) neither corporation could be said to be acquiring the other.

Id., at 68-69.

³⁰⁸ *Unocal v. Mesa Petroleum*, supra note 237.

³⁰⁹ Thus, although Chancellor Allen does not deny the defensive value of the impending resolution of Time's directors, he ultimately considers it as merely collateral to the "achievement of the long-term strategic plan of the Time-Warner consolidation." *Id.*, at 86.

³¹⁰ *Id.*

that directors may consider in their corporate choices, he indirectly addressed it by upholding Time directors concerns for the defense of “Time culture”.

As stated by one of Time’s directors, Mr. Honer:

... editorial freedom free from political or other kinds of intervention is absolutely essential if members of our society are to be enlightened enough to form wise judgments and fulfill their responsibilities as citizens. That feeling on my part coincides with the interests of Time stockholders. The editorial integrity I value is also a tremendous source of value to the company and its stockholders. Without it, Time magazine and the company's other magazines would lose their loyal readers and advertisers, and Time's revenues and value would suffer. The governance provisions were necessary to ensure Time writers and editorial personnel that editorial independence would continue to be respected at Time. Otherwise the integrity and ultimately the financial viability of the institution would be threatened.³¹¹

In this light, preserving “Time culture” becomes shorthand for pursuing the benefit of the corporation as a whole. Hence, the idea of the corporation as an institution with a broader social purpose emerges in between the lines of *Paramount v. Time* and shapes the final outcome of this decision.³¹²

³¹¹ *Id.*, at 21.

³¹² To the point, Chancellor Allen further observes "I am not persuaded that there may not be instances in which the law might recognize as valid a perceived threat to a

From an economic perspective, Chancellor Allen's decision has the merit of introducing two basic novelties in the judicial analysis of directors' fiduciary duties. The first is that maximizing the value of existing shareholders is not always ex-post efficient. The second is that efficient corporate decision-making implies optimization along the temporal dimension. This point, in particular, is crucial because it introduces the idea that social welfare is a dynamic rather than static measure. In this light, the maximization of social welfare may require sacrificing the current interest of

'corporate culture' that is shown to be palpable (for lack of a better word), distinctive and advantageous." *Id.*, at 13-14. Millon has been among the strongest supporter of a reading of *Paramount v. Time* as a case that marks an inversion in the judicial attitude vis-à-vis the nature of the corporation:

To explain why preservation of Time's corporate structure in its existing form was significant, Allen might have referred to the maintenance of jobs or of business relationships with creditors, suppliers, and others dependent on Time's continued existence. Instead, the importance of "Time culture," and thus the justification for management's efforts to preserve the corporation intact, lay in the public's interest in the ongoing operation of the business in more or less the same manner as it had been conducted during recent decades. Disruption or destruction of Time's business would be harmful to the American public, so management's efforts to preserve it, by merging with Warner and blocking the Paramount tender offer, were justified."

Millon, *supra* note 131, at 257.

Advocates of the shareholder primacy, however, give a completely different interpretation of *Paramount v. Time*, arguing that this decision merely re-establish directors' discretionary power to determine which corporate strategy pursues the best interest of shareholders, regardless of the time's horizons of such a choice. *See* Millon, *supra* note 131, at 258 (reporting such an argument).

one category for the interest of the future value of another (or even the same) category.

3. The Team Production Model (TPT)

In addition to the shareholder primacy norm and the entity model, there is a third model of directors' fiduciary duties: that developed under the team production theory (TPT) of corporate law. Professor Margaret Blair and Lynn Stout have articulated this theory in a series of influential articles.³¹³ For the purpose of this discussion, I briefly address the model proposed by Blair and Stout and then focus my attention on the TPT's analysis of directors' fiduciary duties.

3.1. The TPT: An Overview

While Blair and Stout rebut the classical contractarian model of corporate law³¹⁴—and, with it, the principle of shareholder primacy—they

³¹³ The fundamental reference is to Blair & Stout, *supra* note 49. See also M.M. Blair & L.A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001) [hereinafter Blair & Stout, *Director Accountability*]; Blair & Stout, *supra* note 166; M.M. Blair & L.A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743 (1999). Blair and Stout explicitly acknowledge that their approach is grounded on a substantial body of prior economic literature, including Alchian & Demsetz, *supra* note 130; B. Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. & MGMT. SCI. 324 (1982); and R.G. Rajan & L. Zingales, *Power in the Theory of the Firm*, 113 Q. J. ECON. 387 (1998).

³¹⁴ According to the Blair and Stout, both the principal-agent model and the property right (or contractual incompleteness) model at the basis of the contractarian elaboration of the corporate system are incomplete in a critical way. The principal-agent

still view the corporation as a nexus of inputs.³¹⁵ Their model, however, does not conceive of corporate relationships as being ordered within a hierarchical structure dominated by shareholders. Instead, under the TPT corporate relationships are the result of horizontal exchanges among the members of a team. The reference is to “[t]he hitherto neglected team production approach”,³¹⁶ imported from the work of economists Armen Alchian, Harold

model “ignores several problems” and, first of all, that of the ambiguity of corporate relationships because in many corporate situations it would be not clear who is the principal and who is the agent. In other words, Blair and Stout argue that shareholders retain too little control over the corporation and its officials to be regarded as principals. The property right model, instead, “is not a theory of corporations”, because it misstates the nature of shareholders’ corporate interests. For Blair & Stout, shareholders merely are one of the inputs of the corporation and, therefore, should not be attributed any particular right. More importantly, neither model offers an account of both the nature and the activity of public corporations. See Blair & Stout, *supra* note 49, at 258-265.

³¹⁵ Another provocative variation on the contractarian model of the corporation is represented by the proposal articulated by Stephen Professor Bainbridge. Bainbridge reviews the traditional nexus of contract approach, claiming that it is the board of directors which serves as the nexus for the various contracts that make up the corporation. The “director primacy model”—as Bainbridge renames his theory of the corporation—is grounded on the premise that the corporation’s distinguishing feature is the existence of a central decision-maker vested with “the power of fiat”. That is, for Bainbridge, the board of directors is essential to solve the uncertainty, complexity, and opportunism characterizing corporate relationships. Bainbridge also uses a team production analysis of the firm, to the extent that he sees the board of directors as the center of power to which team members willingly delegate this power of fiat. However, under the TPT “hierarchs work for team members (including employees) who ‘hire’ them to control shirking and rent-seeking among team members. Instead, under Bainbridge’s director primacy model directors hire the factors of productions, not *viceversa*. See Bainbridge, *supra* note 1; Bainbridge, *supra* note 134.

³¹⁶ See Blair & Stout, *supra* note 49, at 258.

Demsetz, and Bengt Holmstrom.³¹⁷ This approach views the corporate activity as requiring the combined investments and coordinated efforts of various team members (i.e. corporate participants)—including shareholders, managers, employees, corporate creditors, and even local communities. Under the TPT, the justification for the existence of corporations is the rational belief of team members that they can earn better return through cooperative endeavor than they can do individually.³¹⁸

On this view, the main purpose of corporate law is to offer a solution to team production problems.³¹⁹ These problems arise for two basic reasons: (i) the specificity of team members' investments (i.e., the fact that such investments tend to have lower re-deployability outside their corporate use),³²⁰ and (ii) the non-separability of production outputs (i.e., the impossibility of determining the value of each team members' contribution to the overall performance of the corporation). Hence, under the TPT the central contracting problem is how to implement an efficient division of the economic surplus (i.e., the rents) generated by joint production. Blair and

³¹⁷ See *supra* note 313.

³¹⁸ See Blair & Stout, *supra* note 49, at 269-270.

³¹⁹ *Id.*, at 249-251.

³²⁰ See O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 55, 115. (1985) (defining specific investments as “durable investments that are undertaken in support of particular transactions, the opportunity cost of which investments is much lower in best alternative uses or by alternative users should the original transaction be prematurely terminated.”)

Stout contend that both *ex-ante* and *ex-post* allocation rules are unsuitable to this end. *Ex-ante* allocation rules invite shirking. When returns from production are predetermined (for example, on some proportional basis), team members will fail to exert optimal efforts. This is because they will get the same share of the total output regardless of their effective commitment to produce it. *Ex-post* allocation rules, instead, incentivize rent-seeking behavior. That is, team members will have an incentive to squabble with each other over the size of their individual pieces, wasting time and efforts. In both cases, the result is the reduction of the overall welfare.

For Blair and Stout, public corporation law offers a second best solution to these problems “because it allows rational individuals who hope to profit from team production to overcome shirking and rent-seeking by opting into an internal governance structure we call the ‘mediating hierarchy’.”³²¹ Under this governance structure, team members willingly give up their rights over corporate assets to a third party, the corporate entity itself.³²² At the same time, they assign the power of control over those assets

³²¹ See Blair & Stout, *supra* note 49, at 250. Blair and Stout recognize that directors’ lack of a direct firm stake may discourage efficient monitoring and management functions. To this extent, the TPT could exacerbate agency costs. Nevertheless, “...if the likely economic losses to a productive team from unconstrained shirking and rent-seeking are great enough to outweigh the likely economic losses from turning over decisionmaking power to a less-than-perfectly-faithful hierarch, mediating hierarchy becomes an efficient second-best solution to problems of team production”. *Id.*, at 283-284

³²² Indeed, it is the corporation that owns corporate assets and has the right to any surplus produced by the team and not distributed among team members. See Blair & Stout, *Director Accountability*, *supra* note 313, at 424.

as well as the rents they generate to an internal hierarchy, at top of which sits the board of directors. Hence, directors' ultimate obligation is to protect the specific investments of each member of the corporate team and, at the same time, ensure that all members receive a large enough share to induce them to invest optimally.

3.2. *The TPT and Directors' Fiduciary Duties*

Although the TPT is a general model of corporate governance,³²³ the discussion of directors' fiduciary obligations is at the center of this model.

As a normative matter, the TPT approach results in the dismissal of the view of shareholders as the only corporate participants holding residual claims over the corporate income stream. For Blair and Stout, *all* team members are residual claimants, because each of them makes a specific investment that leaves her vulnerable to potential opportunistic exploitations by other team members. Moreover, the value of each team member's corporate investment depends, explicitly or implicitly, on overall firm performance (i.e., joint production).³²⁴ Hence, it no longer makes sense to

³²³ Blair and Stout claim that the TPT better describes existing corporate law than any other theoretical corporate governance model. To show this, they take into exam several aspects of corporate law, including derivative claim rules, the business judgement rule, and shareholder voting rights. Nonetheless, critics of the TPT have argued that it has at best a normative but not positive value, suggesting that "legal doctrine--particularly in the centrally important areas analyzed by Blair and Stout--bears a stronger shareholder primacy imprint than an imprint of TPM." *See* Millon, *supra* note 49, at 1021.

³²⁴ Blair and Stout suggest that the case of employees is exemplar to this respect.

describe shareholders as the sole residual risk bearers and, therefore, as the sole beneficiary of directors' fiduciary duties.

As a positive matter, Blair and Stout argue that corporate law lacks any provision requiring directors to act as instructed by shareholders or to maximize shareholder wealth.³²⁵ Instead, directors enjoy “an extraordinary degree of discretion” in the corporate decision-making process.³²⁶ By contrast, conceiving of the board as a mediating hierarchy perfectly fits the wide leeway the law grants directors. This conceptualization of the board explains why directors need to hold ultimate decision-making power over the firm. It also explains why directors cannot be subordinated to the control of any corporate constituency.³²⁷

Employees make firm-specific investments (in terms of knowledge, skills, contacts), which have no corresponding value outside that particular firm. They accept to make such investments based on the assumption that they will be rewarded in the long run through wage increases, promotions, and so on. This expectation, however, is legally unenforceable most of the times. Hence, employees also bear a significant residual risk, because bad firm performance can frustrate their “investment expectations” and, at the extreme, result in the employees' layoff. Blair & Stout, *Director Accountability*, *supra* note 313, at 414-415.

³²⁵ See Blair & Stout, *supra* note 49, at 291 (“Shareholders can elect directors and, under some circumstances, remove them--but they cannot tell them what to do.”).

³²⁶ See *id.*, at 252.

³²⁷ Blair and Stout argue that derivative claim rules and the attribution of voting rights to shareholders only apparently dismiss this view of the corporation. In fact, these special rights are attributed to the shareholders only because they are in the best position to represent the interests of all team members, i.e., the corporate interest. Thus, a closer inspection of the legal rules applying to derivative claims shows that shareholders' action is

The TPT has the merit of introducing a solution to the problem of ex-post efficiency that may arise within corporate fiduciary relationships. While this theory only addresses the issue of the intrinsic incompleteness of corporate contracts to a limited extent,³²⁸ from a normative viewpoint it offers an answer to this matter. Under the mediating hierarchy model, directors can be viewed as charged with the task of completing incomplete contracts to the benefit of the team as a whole. On the other hand, however, the TPT's conceptualization of directors' fiduciary duties may raise ex-ante uncertainty. This is because this theory fails to provide clear guidance about directors' gap-filling role, especially as concerns potential situations of conflict of interests among the various team members. Blair and Stout only claim that there is enough "play in the joints" under the TPT for directors to favor one constituency's interests over another's, as long as they can allocate to team members a share of the total outcome that is sufficient to keep members in the team.³²⁹ But how can directors establish what this share is?

Put another way, the TPT lacks constraining force. While to some extent I share Blair and Stout's argument that reputational concerns help to keep directors faithful, I also argue that this alone is insufficient to advance

designed to serve the interests of the firm as a whole, rather than the interests of shareholders per se. Similarly, shareholders' voting rights are mostly designed to serve the interests of all stakeholders. See Blair & Stout, *supra* note 49, at 292-315; Blair & Stout, *Director Accountability*, *supra* note 313, 426-434.

³²⁸ See *supra* text accompanying note 315.

³²⁹ See Blair & Stout, *Director Accountability*, *supra* note 313 at 435.

corporate efficiency. Relying exclusively on reputational capital to police directors' misconduct means assuming a perfect labor market. This, however, appears as a rather implausible assumption. Instead, as I will explain in the following Chapter, bright and predictable rules are necessary for an effective enforcement of directors' duties.

V. THE CREDITOR VARIANT

Part IV of this research has explained why modern corporate law discussions about the central question of the beneficiary of corporate fiduciary duties have failed to produce a normative paradigm that moves past ideological positions. This view also helps to better understand why this debate, as reflected in the unending tension between contractarians and communitarians, is far away from a resolution. As suggestively observed by one commentator “like the combatants in Vietnam, both sides appear to have declared victory and moved on to other endeavors.”³³⁰

In this Part, I focus on a different approach to corporate fiduciary duties, which I rename as the “creditor variant” of corporate fiduciary law.³³¹ Under this variant, U.S. courts have recognized that directors might owe duties to creditors upon some specified contingencies. Historically, these contingencies have coincided with the decline of the financial conditions of the corporation, that is, the occurrence of insolvency.³³² As the ensuing

³³⁰ Lipson, *supra* note 67, at 1236.

³³¹ For a discussion of the historical evolution of this paradigm, *see* Bratton, *supra* note 141, at 106-113.

³³² Among the cases holding the directors of insolvent corporations liable to creditors for breach of fiduciaries duties, *see, e.g.*, Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (In re STN Enters.), 779 F.2d 901, 904 (2d Cir. 1985) (Vermont law); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981) (New York law) FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982) (South Carolina law); Brown v. Presbyterian Ministers Fund, 484 F.2d 998, 1005 (3d Cir. 1973) (Pennsylvania law) (superseded by state statute); Automatic Canteen Co. of Am. v. Wharton, 358 F.2d 587, 590 (2d Cir. 1966)

discussion will show, this articulation of the creditor variant underlies both the so-called *trust fund doctrine* and the U.S. Bankruptcy Code.³³³ Under the influence of the contractarian paradigm, most corporate law scholars have interpreted the creditor variant as supporting the idea that the positive mandate of the duty of loyalty essentially is a function of payoff structures and priority rights. Put another way, these scholars view insolvency as an exception to the rule that directors exclusively owe duties to shareholders because in insolvent corporations creditors take the place of shareholders as residual claimants.³³⁴

(Indiana law); Official Comm. of Unsecured Creditors of Toy King Distribus. v. Liberty Sav. Bank (In re Toy Distribs., Inc.), 256 B.R. 1 (Bankr. M.D. Fla. 2000); Brandt v. Hicks, Muse & Co. (In re Healthco, Int'l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass. 1997) Beemer v. Crandon Enters. (In re Holly Hill Medical Ctr., Inc.), 53 B.R. 412, 413-14 (Bankr. M.D. Fla. 1985); Waldschmidt v. Gilly (In re IMI, Inc.), 17 B.R. 784, 786-87 (Bankr. E.D. Wis. 1982); Roberts v. Geremia (In re Roberts, Inc.), 15 B.R. 584, 586 (Bankr. D. R.I. 1981); A.R. Teeters & Assoc. v. Eastman Kodak Co., 836 P.2d 1034, 1043 (Ariz. Ct. App. 1992); Francis v. United Jersey Bank, 432 A.2d 814, 824 (N.J. 1981); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992); Snyder Elec. Co. v. Fleming, 305 N.W.2d 863, 869 (Minn. 1981); Hixson v. Pride of Texas Distrib. Co., Inc., 683 S.W.2d 173, 176 (Tex. Ct. App. 1985)

³³³ See *infra* Part V.2.

³³⁴ See, e.g., Brudney, *Corporate Bondholders and Debtor Opportunism*, *supra* note 162; G.S. Corey et al., *Are Bondholders Owed a Fiduciary Duty?*, 18 FLA. ST. U. L. REV. 971, 993 (1991); R. de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45 (1998); L. Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485 (1993); Lipson, *Directors' Duties*, *supra* note 67, at 1200-1201; DeBow & Lee, *supra* note 265, at 398; J.C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207,

I suggest, however, that the view of the creditor variant as an "isolated exception" to shareholder primacy is again the result of an ideological position. The modern corporate finance canon helps to better understand why. This canon teaches that when a corporation has outstanding debt, equity payoff becomes asymmetric. This means that shareholders profit from the undertaking of risky projects to detriment of debtholders.³³⁵ Being shielded by limited liability and holding a residual claim to corporate profits, shareholders expect in fact to reap all the upside potential from riskier projects. Instead, debtholders, as fixed claimants, bear most of the downside losses from such projects. Importantly, this problem is not only distributional, but also concerns allocative efficiency. This is because shareholders' distorted risk preferences may result in the undertaking of projects that are individually efficient for them but socially inefficient, i.e., projects with negative net present value.

A simple example is useful to better understand the implications of

1255-56 (1991); V. Jelisavcic, *Corporate Law-A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duties to Creditors in the "Vicinity of Insolvency": Credit Lyonnais v. Pathe*, 18 J. CORP. L. 145 (1992); S.R. McDonnell, *Comment, Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden From Shareholders to Creditors*, 19 DEL. J. CORP. L. 177 (1994); H.R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1477-1478 (1993); S.L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 667-68 (1996); G.V. Varallo & J.A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992).

³³⁵ See *supra* note 10.

this form of shareholder opportunism. Consider the case of a corporation whose capital structure is represented by equity capital, E . The directors can decide to undertake two different investments: Investment 1 or Investment 2. Investment 1 generates revenues R_L with probability p_H and 0 with probability $(1 - p_H)$. Instead, Investment 2 generates revenues R_H with probability p_L and 0 with probability $(1 - p_L)$. In this example, I make the following assumptions:

$$(A1) \quad p_H > p_L;$$

$$(A2) \quad R_L < R_H; \text{ and}$$

$$(A3) \quad p_H R_L > p_L R_H.$$

This means that: (i) Investment 2 is riskier than Investment 1; (ii) in the event of success Investment 2 delivers a higher payoff relative to Investment 1; and, finally, (iii) the present value of Investment 1 is higher than the present value of Investment 2. Under this binary investment choice, if the corporation is exclusively funded through equity, it is easy to see that Investment 1 maximizes shareholder wealth. Indeed, the undertaking of Investment 2 would reduce shareholder and corporate value by $p_H R_L - p_L R_H$. However, assume now that the capital structure also includes debt, D . Under this different capital structure, the shareholders' payoffs change as follows: under Investment 1 they expect to receive $p_H(R_L - D)$, while under Investment 2 they expect to get $p_L(R_H - D)$. Hence, whenever $D > \frac{p_H R_L - p_L R_H}{p_H - p_L}$, Investment 2 maximizes shareholder value at the expense of debtholder value and, potentially, aggregate welfare.

Even more important, as leverage increases, shareholders may have incentives to undertake value-decreasing projects, because higher leverage increases the amount of losses that is borne by debtholders rather than shareholders. Since the condition that makes Investment 2 profitable for the shareholders is $D > \frac{p_H R_L - p_L R_H}{p_H - p_L}$, it is easy to see that the shareholders' incentives to undertake riskier investments are increasing in the level of debt (D). This means, in practice, that the undertaking of Investment 2 might lead to a social welfare loss equal to $p_H R_L - p_L R_H$.

This simple example offers several intuitions. First, it suggests that a corporate fiduciary law system that is centered on shareholder wealth maximization might be “systemically biased” in favor of excessive risk-taking,³³⁶ at least when the level of corporate debt is high. Second, as a corollary, it suggests that holding corporate insolvency an isolated exception to the application of shareholder primacy rule is untenable. This is because the reasons justifying this exception also apply to other circumstances. Indeed, if one uses what I call the “reversed residual claimant” argument to justify the shift of fiduciary duties to creditors upon insolvency, she should acknowledge that this same argument applies to creditors of highly leveraged corporations with risky projects. Third, and most importantly, this example suggests that the creditor variant is better described as a state-contingent approach to fiduciary duties. Requiring directors to maximize shareholder wealth may increase overall welfare in some circumstances. However, it may

³³⁶ See *supra* note 13.

lead to the opposite result in others, with insolvency only being one of these “other circumstances”. This last observation finds support in the most recent evolution of the creditor variant as articulated in the path breaking decision of Chancellor Allen in *Credit Lyonnais*,³³⁷ which acknowledged the existence of directors’ duties to creditors prior to insolvency.³³⁸ Finally, a thorough reading of the evolution of the creditor variant at common law suggests that a state-contingent approach to fiduciary duties is a desirable direction to move toward an ideology-free paradigm of corporate fiduciary law.

1. The “Trust Fund” Doctrine

The origins of the creditor variant of corporate fiduciary law can be traced back to the development of the *trust fund doctrine*, which establishes that the assets of a corporation facing dissolution are held in trust to the benefit of the company’s creditors.³³⁹

The original elaboration of the doctrine dates back to the landmark 1824 case of *Wood v. Dummer* (“*Wood*”),³⁴⁰ in which the creditors of a

³³⁷ *Credit Lyonnais*, *supra* note 34. See also *infra* Part V.3.1.

³³⁸ As discussed *infra*, *New York Credit Men’s Adjustment Bureau Inc. V. Weiss*, 110 N.E.2d. 397 (N.Y. 1953) is the historic precedent of *Credit Lyonnais*. See *infra* text accompanying notes 352-56.

³³⁹ For a thorough discussion of the trust fund doctrine, see J.J. Norton, *Relationship of Shareholders to Corporate Creditors upon Dissolution: Nature and Implications of the “Trust Fund” Doctrine of Corporate Assets*, 30 BUS. LAW. 1061 (1975); Varallo & Finkelstein, *supra* note 334.

³⁴⁰ *Wood v. Dummer*. 30 F. Cas. 435 (C.C.D. Me. 1824).

liquidating bank brought action against the bank shareholders to seek reimbursement of their claims out of illegitimate dividend payments. Justice Story, sitting circuit, held that because the bank was insolvent, approving a dividend distribution amounted to “misconduct”. It therefore required the shareholders to return the distribution to the creditors. His elaboration of the basis for relief offers the original articulation of the trust fund doctrine:

The capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. (...). The charters of United States banks make the capital stock a trust fund for the payment of all the debts of the corporation. The bill-holders and other creditors have the first claims upon it; and the stockholders have no rights, until all the other creditors are satisfied. (...) Their rights are not to the capital stock, but to the residuum after all demands on it are paid. On a dissolution of the corporation, the bill-holders and the stockholders have each equitable claims, but those of the bill-holders possess a prior exclusive equity.³⁴¹

Wood provided the ground for further judicial application of the trust fund theory.³⁴² In a series of early rulings, the Supreme Court expanded the

³⁴¹ *See id.*, at 436.

³⁴² *See, e.g.*, *Mackenzie Oil Co. v. Omar Oil & Gas Co.*, 120 A. 852 (Del. Ch. 1923); *Asmussen v. Quaker City Corp.*, 156 A. 180 (Del. Ch. 1931); *Reif v. Equitable Life Assur. Soc’y*, 197 N.E. 278 (N.Y. 1935); *People v. Metro Sur. Co.*, 98 N.E. 412 (N.Y. 1912); *Pennsylvania Co. for Insurance On Lives & Granting Annuities v. South Broad St. Theater Co.*, 174 A. 112, 116 (Del. 1934); *Heaney v. Riddle*, 23 A. 2d 456 (Pa. 1942).

trust in favor of creditors of liquidating corporations to all the corporate assets,³⁴³ including unpaid subscriptions to the capital stock.³⁴⁴ But the crucial moment in the evolution of the doctrine coincides with a series of later cases focusing on the elaboration of the trust's triggering event. *Wood* and most of the early cases identified the company's dissolution as the moment triggering the trust to the benefit of creditors. For most commentators, this suggests that what prompted the development of the trust fund doctrine was the judiciary's attempt to grant creditors of insolvent corporations equitable protection against the general common law rule of no-post dissolution liability.³⁴⁵ A variant of this conceptualization holds that the

³⁴³ See *Curran v. Arkansas*, 56 U.S. 15 How. 304, 306-307 (1853). The case in *Curran* involved an action against state legislature as an insolvent bank's principal shareholder, based on the claim the assets of the bank ought to be used to pay back plaintiff's interest as creditor. The court held that the fact that the capital stock of the bank corporation came from the state did not affect plaintiff's right as a creditor to be paid out of the bank's property since the assets of the insolvent bank were to be deemed as held in trust to the benefit of its creditors. Some commentators have observed that the Supreme court's ruling in *Curran* transformed the nature of creditors' trust from "something approaching a lien" (as held in *Wood*) to an express lien. See also *Conaway Stilson*, *supra* note 167, at 81.

³⁴⁴ *Sawyer v. Hoag*, 84 U.S. (17 Wall.) 610 (1873). The defendant in this case was an insolvent insurance corporation (a quasi-public enterprise) that operated under a special state concession requiring a capital stock account of \$100,000. The court held that the directors' failure to ensure the payment of \$90,000 of a corporation's capital stock account amounted to fraud because it had shifted business risk from shareholders to creditors. See *id.*, at 620. ("Though it be a doctrine of modern date, we think it now well established that the capital stock of a corporation, especially its unpaid subscriptions, is a trust fund for the benefit of the general creditors of the corporation.").

³⁴⁵ The trust fund doctrine resolved one of the knottiest problems in early American

doctrine's development was due to the lack of fraudulent-conveyance statutes in early American corporate law.³⁴⁶ From this perspective, it is unsurprising that the trust in favor of creditors was ultimately conditioned on court intervention, i.e., the beginning of legal proceedings against the insolvent corporation. Indeed, a court's disposition was necessary to establish the dissolution of "the corporate persona".³⁴⁷ The Supreme Court's ruling in the 1893 case of *Hollins v. Brierfield Coal & Iron Co.* is paradigmatic of this early line of authority:

Solvent, [the corporation] holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien...Becoming insolvent, the equitable interest of the stockholders

corporate: namely, the common law rule under which the lands and tenements of a reverted to their respective grantors upon dissolution, with consequent extinction of the corporation's debts. *See e.g.* *Nevitt v. The Bank of Port Gibson* (14 Miss. (6 S. & M.) 513 (1846)), in which Chancellor Kent held that to applying this "odious and obsolete doctrine of ancient date . . . would be a disgrace to any civilized state", concluding that the property of a dissolved corporation was to be deemed as held in trust fund for the benefit of its creditors. *See* N.P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 *DePaul L. Rev.* 655, 659-62 (1992); Conaway Stilson, *supra* note 167, at 77-78.

³⁴⁶ *See* J.C. Coffee, Jr., *Court Has a New Idea on Directors' Duty*, *NAT'L L.J.*, Mar 2., 18 (1992) (arguing that that the remedies granted to creditors under the trust fund doctrine would be available today under the provisions of both the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act). *But see* Beveridge, *supra* note 345, at 614-16 (observing that although both doctrines are finalized to sanction fraudulent transactions, fraudulent conveyance is applicable to both corporations and other kinds of debtors).

³⁴⁷ Conaway Stilson, *supra* note 167, at 86-87.

in the property, together with their conditional liability to the creditors, places the property in a condition of trust, first, for the creditors, and then for the stockholders. (...) It is rather a trust in the administration of the assets after possession by a court of equity than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder.³⁴⁸

The subsequent development of the trust fund doctrine, however, moves past the requirement of judicial intervention, conditioning the rise of the trust in favor of creditors to the mere fact of insolvency. In the 1944 case of *Bovay v. H.M. Byllesby & Co.*, the court held that “[t]he fact which creates the trust is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided on very different principles than in the case of solvency.”³⁴⁹ Hence, *Bovay* can be regarded as one of the first cases endorsing an insolvency exception to the

³⁴⁸ *Hollins v. Brierfield Coal & Iron Co.*, 150 U. S. 371, 383 (1893). Finally, the Supreme Court refused to apply the “trust fund” doctrine because the plaintiffs had not first reduced their claims to a judgment through the beginning of a legal proceeding against the insolvent debtor corporation.

³⁴⁹ See *Bovay v. Hm Byllesby & Co.*, Del. Supr., 38 A.2d 808, 813 (1944) (concerning a fraudulent diversion of corporate assets by the directors of a bankrupt corporation in favor of the company’s stockholders who had appointed them). Other cases in this line of authority include, for example, *People v. Metro*, *supra* note 342; *Heaney v. Riddle*, *supra* note 342; *Bank Leumi-Le-Israel, Philadelphia Branch v. Sunbelt Indus., Inc.*, 485 F. Supp. 556 (S.D. Ga. 1980); *Clarkson Co. v. Shaheen*, *supra* note 332; *FDIC v. Sea Pines Co.*, *supra* note 332; *In re STN Enters*, *supra* note 332; *Askanase v. Fatjo*, Civil Action No. H-91-3140, 1993 U.S. Dist. LEXIS 7911 (S.D. Tex. Apr. 22, 1993).

rule of fiduciary duties to shareholders. This endorsement marks the evolution of the trust fund doctrine from an equitable remedy to a condition-based attribution of fiduciary duties to creditors. Economically, this shift in the beneficiary of fiduciary duties finds its justification in the same residual claimant argument that is used to explain the attribution of fiduciary duties to the shareholders of a solvent corporation.³⁵⁰ Under this argument, creditors take the place of shareholders as the parties who have an equitable interest in the corporation's assets upon insolvency.³⁵¹

While plausible, the “reversed residual claimant” explanation of the trust fund doctrine emerges as restrictive once the subsequent judicial evolution of the doctrine is taken into account. Indeed, in the 1955 case of *New York Credit Men's Adjustment Bureau Inc. v. Weiss* (“*New York Credit*”), the court held that “the imminence of insolvency” was a sufficient condition to establish the trust in favor of creditors.³⁵² *New York Credit* arose out of a claim brought against the company's directors by the bankruptcy trustee, who claimed that the directors had failed to obtain the maximum

³⁵⁰ See, e.g., Lipson, *supra* note 67, at 1204; McDonnell, *supra* note 334, at 185; Schwarcz, *supra* note 334, at 647-648.

³⁵¹ See Schwarcz, *supra* note 334, at 667. It is important to observe that Justice Story's ruling in *Wood v. Dummer* already contained the seeds of this conceptualization: “[t]he stockholders have no right to any thing but the residuum of the capital stock, after payment of all the debts of the bank. The funds in their hands, therefore, have an equity attached to them, in favour of the creditors, which it is against conscience to resist.”) See *Wood v. Dummer*, *supra* note 339, at 439.

³⁵² See *New York Credit*, *supra* note 338, at 399.

value from the auction sale of corporate assets. While corporate assets' value was approximately \$60,000 (with book value of \$70,000), the auction only netted \$20,000.³⁵³ Although the action was formally based upon a New York statute,³⁵⁴ the court applied the trust fund doctrine and held that “[i]f the corporation was then technically solvent but insolvency was approaching and was then only a few days away, defendants, as officers and directors, were, in effect, trustees by statute for the creditors.”³⁵⁵ While at a first sight *New York Credit* might only seem to create “a presumption of insolvency immediately before insolvency-in-fact”,³⁵⁶ I argue that this case has more fundamental implications. Indeed, an enlightened interpretation of *New York Credit* suggests a different motivation for this decision: the rationale supporting a

³⁵³ *Id.*

³⁵⁴ The bankruptcy trustee relied on § 60 of the New York General Corporation Law, which provided, among others, that:

An action may be brought against one or more of the directors or officers of a corporation to procure judgment for the following relief or any part thereof: (...) 2. To compel them to pay to the corporation, or to its creditors, any money and the value of any property, which they have acquired to themselves, or transferred to others, or lost, or wasted, by or through any neglect of or failure to perform or other violation of their duties.

N.Y. BUS. CORP. LAW § 60 (Consol. (1943)), re-enacted and modified in N.Y. BUS. CORP. LAW § 720 (Consol. 1986 & Supp. 1993)). It is worth observing that critics of the trust fund doctrine have observed that the court's final judgment could have been reached through mere reference to this statutory provision.

³⁵⁵ See *New York Credit*, *supra* note 338, at 398.

³⁵⁶ <http://www.kirkland.com/siteFiles/kirkexp/publications/2529/Document1/Zone%20of%20Insolvency-%20Updated%202002.pdf> (practitioners' interpretation).

shift of fiduciary duties to creditors upon insolvency may as well hold before insolvency is (formally) triggered.

In the context of the generalized imbalance of the American corporate system in favor of the shareholder primacy rule, it should come as no surprise that the trust fund doctrine has encountered much criticism. Critics have argued that the doctrine was born as an equitable principle³⁵⁷ and only established directors' duties in favor of creditors in the presence of "exceptionally compelling facts which warrant the abdication of explicit dissolution legislation or alternative legal remedies".³⁵⁸ This means, in practice, that trust fund principles are at best redundant in light of the

³⁵⁷ See, e.g. Norton, *supra* note 339 ("In its origin the trust fund doctrine must be seen as a peculiar creature of equity, having no foundation in common law or general corporate principles; an extraordinary device used to achieve fair and just result.")

³⁵⁸ Conaway Stilson, *supra* note 167, at 90 (including among the circumstances that compelled the early courts to utilize the doctrine

"(1) corporate defendants with a public character -- e.g., banks, insurance companies, and railroads; (2) corporations which required substantial initial capitalization (but from which capitalization was not forthcoming by equity participants) to protect the public investors who deposited their funds with the defendant firms; (3) distributions to stockholders in preference to unpaid creditors at the moment of insolvency or dissolution of the corporation; and (4) disputes which focused solely upon creditors as against stockholders and not disputes among creditors inter se.

Id. See also Beveridge, *supra* note 345, at 621 ("an implied fiduciary duty by corporate directors (...) to the creditors of an insolvent or nearly insolvent corporation when there is no controlling statute or judicial intervention")

evolution of modern corporate law rules.³⁵⁹ I argue, however, that this criticism is positively unfounded for three reasons. First, it fails to take into full account the evolution of the trust fund paradigm, which radically departs from its original elaboration as an equitable principle. Second, as the ensuing discussion will show, it misses one important point: the elaboration of special circumstances in which directors might owe fiduciary duties to creditors is not peculiar to the trust fund doctrine. Instead, Chapter 11 of the U.S. Bankruptcy Code also provides for similar circumstances. Third, Chancellor's Allen famous decision in *Credit Lyonnais* shows that the trust fund doctrine is everything but redundant almost 200 years after Justice Story's original elaboration.

2. Directors' Duties to Creditors under Chapter 11

The U.S. Bankruptcy Code includes two separate bankruptcy procedures for business entities: Chapter 7, which is used to liquidate insolvent firms and Chapter 11, which is used to reorganize distressed

³⁵⁹ Every state has enacted one of the uniform fraudulent transfer laws. See Unif. Fraudulent Conveyance Act, 7A U.L.A. 2 (1918); Unif. Fraudulent Transfer Act, 7A U.L.A. 266 (1984). The Bankruptcy Code also contains its own prohibition on fraudulent transfers. 11 U.S.C. § 548 (2000). Further, most corporation statutes contain provisions establishing the liability of corporate directors for distributions of dividends or other corporate property that are made when the corporation is insolvent or cause insolvency. See Lipson, *supra* note 67, at 1206, fn. 75-76. Further, the critics of the doctrine suggests that even if it interpreted as effectively establishing an insolvency exception in favor of creditors, its practical importance would be limited by the business judgment rule, which would expand to protect directors also vis-à-vis creditors. See, e.g., Varallo & Finkelstein, *supra* note 334.

firms.³⁶⁰

³⁶⁰ It is important to emphasize that this discussion of Chapter 11 is limited to aspects involving directors' duties. For more comprehensive accounts of Chapter 11's underlying law and economics issues, see D.G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); D.G. Baird, *A World Without Bankruptcy*, LAW & CONTEMP. PROBLEMS 173, 182 (1987); L.A. Bebhuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); M.E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should Be Cancelled Altogether?*, 58 GEO. WASH. L. REV. 1214 (1990); M. Bradley & M. Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); J.R. Franks & W.N. Torous, *A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations*, 35 J. FIN. ECON. 349 (1994); T.H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986); M.J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983); D.A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992); M.J. White, *The Corporate Bankruptcy Decision*, J. ECON. PERSP. 129 (1989); M.J. White, *Does Chapter 11 Save Economically Inefficient Firms?*, 72 WASH. U.L.Q. 1319 (1994); W.C. Whitford, *What's Right About Chapter 11*, 72 WASH. U.L.Q. 1379 (1994). Among the studies focusing on directors' duties under Chapter 11, see M.J. Bienenstock, *Conflicts Between Management and the Debtor in Possession's Fiduciary Duties*, 61 U. CIN. L. REV. 543 (1992); D.B. Bogart, *Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back -- Something May Be Gaining On You"*, 68 AM. BANKR. L.J. 155, 180 (1994); S.H. Case, *Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases*, in Williamsburg Conference on Bankruptcy 373 (ALI-ABA Invitational Conference) 1988; Miller, *Corporate Governance in Chapter 11*, *supra* note 334; J.T. Roache, *The Fiduciary Obligations of a Debtor In Possession*, 1993 U. ILL. L. REV. 133 (1993); E.M. Ryland, *Bracing For the "Failure Boom": Should a Revlon Auction Duty Arise in Chapter 11?*, 90 COLUM. L. REV. 2255, 2259 (1990); D.A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 500 (1994); G.G. Triantis, *A Theory of the Regulation of Debtor-In-Possession Financing*, 46 VAND. L. REV. 901 (1993); J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of*

The Bankruptcy Reform Act of 1978 introduced Chapter 11 as a reform of the former Chapter X and XI of the U.S. Bankruptcy Code,³⁶¹ based on the assumption that under specific circumstances “it is more efficient to reorganize than liquidate [an insolvent corporation], because it preserves job and assets.”³⁶²

The distinguishing feature of the new bankruptcy procedure introduced by Chapter 11 is that—unlike a procedure under Chapter 7—it does not require the appointment of a trustee to manage bankrupt corporations. The rationale for this policy choice is that incumbent directors might have more chances to reorganize successfully a troubled corporation

Creditors or Stockholders?, 21 UCLA L. Rev. 540, 543 (1973).

³⁶¹ Pub. L. No. 95-598, 92 Stat. 2549 (1978), 11 U.S.C. § § 1101-1174 (1988). The former Chapter X of the U.S. Bankruptcy Code was designed for firms with public debt or equity and required the appointment of a trustee to manage the bankrupt firm. It also assigned a significant oversight role to the Securities and Exchange Commission (SEC) in order to ensure the fairness of reorganization plans. Chapter XI, instead, governed the reorganization of private companies and left incumbent management in charge of the bankrupt entity, contemplating no role for the SEC. *See* Chandler Act of 1938, ch. 575, 52 Stat. 840 (repealed by Pub. L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2682 (1978)). For general discussions of Chapters X and XI as compared to the new Chapter XI of the Bankruptcy Code, see J. J. WHITE, *BANKRUPTCY AND CREDITORS' RIGHTS*, 281-89 (1985).

³⁶² See H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179 (“The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.”); 123 CONG. REC. H35, 444 (daily ed. Oct. 27, 1977) (statement of Rep. Rodino) (“For businesses, the bill facilitates organization, protecting investments and jobs

because of the familiarity with corporate affairs.³⁶³ Therefore, upon a Chapter 11 filing the corporation is transformed into a *debtor in possession* (DIP) and the incumbent directors assume the powers and duties of trustees, assuming liability for the preservation and administration of the debtor's estate.³⁶⁴ The immediate consequence of this liability assumption is that while the incumbent board continues to perform decision-making functions, a bright line is traced as concerns the beneficiary of that function. After a Chapter 11 filing, directors' duties are no longer borne to the exclusive benefit of corporate stockholders but also to the benefit corporate creditors (and, potentially, other stakeholders). As established in *Commodity Futures Trading Commission v. Weintraub*, "if a debtor remains in possession, the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession".³⁶⁵

³⁶³ H.R. REP. NO. 595, *supra* note 362, at 232-34, reprinted in 1978 U.S.C.C.A.N. at 6191-94. The corollary argument is that managers subject to the threat of a court-appointed trustee might wait too long before filing for reorganization, increasing the likelihood of liquidation over reorganization. *Id.*

³⁶⁴ See 11 U.S.C. § 1101(1), 1104, 1107, 1108 (1988).

³⁶⁵ *Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 355 (1985). It is important to observe, however, the principle that the beginning of a reorganization procedure leads to a radical change in the structure of directors' fiduciary duties is not borne with the new Chapter 11. Instead, the first articulation of this principle dates back to the 1963 case Supreme Court's case of *Wolf v. Weinstein* ("Wolf"), as an application of the former Chapter X of the Bankruptcy Code. In *Wolf*, a bankruptcy trustee had exceptionally not been appointed. Nonetheless, the Supreme Court held that the corporation's President and General Manager, as the officers of the debtor in possession performing those functions that would otherwise be performed by a disinterested trustee,

Similarly, in *Fulton State Bank v. Schipper (In re Schipper)* the court stated that the nature of the fiduciary obligations of DIP directors involves a duty of loyalty owed to both creditors and shareholders.³⁶⁶

However, the operational content of DIP directors' fiduciary duties is less clear.³⁶⁷ To the point, the Bankruptcy Code only provides that DIP directors have the obligation to represent the estate—comprised of all of the company's legal and equitable property interests—which is created upon a

were to be considered “fiduciaries” as they had been expressly appointed under § 249 of the former Bankruptcy Act. Therefore, they owed to the debtor's creditors and stockholders the same responsibilities and obligations of an appointed trustee:

so long as the Debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession.... [I]n practice these fiduciary responsibilities fall not upon the inanimate corporation, but upon the officers and managing employees who must conduct the Debtor's affairs under the surveillance of the court.”

Wolf v. Weinstein, 372 U.S. 633 (1963). Because of the wording of the Court's opinion, *Wolf* can be described as an ante-litteram application of the DIP principles later enforced by the new Chapter 11. Thus, it should note as a surprise that in *Commodity Futures* the court made explicit reference to *Wolf*.

³⁶⁶ *Fulton State Bank v. Schipper (In re Schipper)*, 112 B.R. 917, 919 (N.D.Ill.1990), *aff'd*, 933 F.2d 513 (7th Cir.1991).

³⁶⁷ *Davis*, *supra* note 189, 15 (1988) (“Although it appears clear that the directors owe a fiduciary duty to all parties in the reorganization, the nature and extent of that duty remains obscure.”); *Miller*, *supra* note 334, at 1467 (“The precise nature of the fiduciary duties of directors of an insolvent corporation to the corporation's creditors and stockholders becomes somewhat vague and diaphanous postinsolvency and after the commencement of a bankruptcy case under chapter 11.”).

Chapter 11 filing.³⁶⁸ It does not specify, however, what this implies in the increasingly common situations of conflicts of interest that may arise in today's multilayered corporate structures. Judicial decisions on the matter are equivocal. Based on the "absolute priority" creditors enjoy under the Bankruptcy Code, some courts have suggested that directors should give preference to the interests of corporate creditors.³⁶⁹ That is, because shareholders of a bankrupt corporation no longer have an equity interest in the corporate assets, they would be no longer entitled to the benefit of fiduciary duties.³⁷⁰ Cases in this line of authority include, for example, *Manville Corp. v. Equity Security Holders Committee (In re Johns-Manville Corp.)*, in which the court established that the stockholders of an insolvent corporation lack any equity interest in the corporation.³⁷¹ More importantly, in *Weintraub* the Supreme Court explicitly stated that: "[b]ankruptcy causes fundamental changes in the nature of the corporate relationships.... [O]ne of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors."³⁷² Other courts, however, have adopted a less radical view of directors' fiduciary duties in Chapter 11 procedures, suggesting that the "Bankruptcy Code does not affect the

³⁶⁸ See 11 U.S.C. § 541 (1988) and 11 U.S.C. § 1106, 1107(a)..

³⁶⁹ See 11 U.S.C. § 726, 1129(b) (1988).

³⁷⁰ See, e.g., Miller, *supra* note 334, at 1490.

³⁷¹ *Manville Corp. v. Equity Security Holders Committee (In re Johns-Manville Corp.)*, 801 F.2d 60, 65 (2d Cir.1986) (concerning a dispute about the election of an insolvent company's directors).

³⁷² *Weintraub*, *supra* note 365, at 355.

applicability of the corporation law of debtor's state of incorporation as it relates to management of the corporation."³⁷³ Based on this different line of authority, DIP directors would owe duties to both shareholders and creditors.³⁷⁴

In light of the above, we can say that DIP directors might not owe fiduciary duties to shareholders, but they undoubtedly owe duties to creditors. The reversed residual claimant argument is the underlying rationale for this extension (if not, shift) of fiduciary duties—exactly as under the much debated trust fund doctrine discussed above.³⁷⁵ The ensuing discussion of the groundbreaking 1991 decision of Chancellor Allen in *Credit Lyonnais* will illustrate why this argument can likewise be extended to corporations “in the vicinity of insolvency” and, potentially, even solvent corporations.

3. State-Contingent Duties: Credit Lyonnais

³⁷³ *In re FSC Corp.*, 38 Bankr. 346, 349 (Bankr.W.D.Pa.1983) (citing 5 Collier on Bankruptcy § 1103.07, at 1103-19 n. 9 (15th ed. 1983)); accord *In re Saxon Indus.*, 39 Bankr. 49, 50 (Bankr.S.D.N.Y.1984); *In re Lionel Corp.*, 30 Bankr. 327, 329 (Bankr.S.D.N.Y.1983)

³⁷⁴ See Miller, *supra* note 334, at 1490 (suggesting that the ultimate goal of Chapter 11 is to rehabilitate troubled corporations and not just pay back creditors); Budnitz, *supra* note 360, at 1249 (highlighting the right of DIP shareholders to both negotiate for a continued stake in the debtor and vote on a reorganization plans); R.T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1064 (1987) (suggesting that eliminating shareholders' power over DIP directors would give the directors too much leeway).

³⁷⁵ See *supra* Part V.1.

If one was to judge the influence of a judicial opinion based on the volume of scholarly and practitioner commentary that opinion engendered, *Credit Lyonnais* would likely stand out as one of the most influential Delaware decisions ever.³⁷⁶ The reason for the upheaval created by this decision rests on its articulation of a new economically grounded fiduciary model, which I defend as being state-contingent and based on rigorous financial parameters.

3.1. *The Decision*

Credit Lyonnais arose “from a leveraged buyout that failed to meet its

³⁷⁶The literature on *Credit Lyonnais* is far beyond extensive; see, e.g., Barondes, *supra* note 334; Beveridge, *supra* note 345; M.J. Bienenstock, *Conflicts Between Management and the Debtor in Possession's Fiduciary Duties*, 61 U. CIN. L. REV. 543 (1992); Davis, *supra* note 367; D.A. DeMott, *Down the Rabbit-Hole and into the Nineties: Issues of Accountability in the Wake of Eighties-Style Transactions in Control*, 61 GEO. WASH. L. REV. 1130 (1993); Hartman, *supra* note 334; Jelisavicic, *supra* note 334; Lin, *supra* note 334; Lipson, *supra* note 67; L.M. LoPucki & W.C. Witford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993); C.R. Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61 (1993); B. Nicholson, *Recent Delaware Case Law Regarding Director's Duties to Bondholders*, 19 Del. J. Corp. L. 573 (1994); Norton, *supra* note 339; R.K.S. Rao et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance In a Financially-Distressed Firm*, 22 J. CORP. L. 53; Conaway Stilson, *supra* note 167; Varallo & Finkelstein, *supra* note 334; D.J. Winnike, *Credit Lyonnais: An Aberration or an Enhancement of Creditors' Rights in Delaware?*, 6 INSIGHTS 31 (1992). It is worth observing that *Smith v. Van Gorkom* and *Revlon* would probably be the other candidate to the role of “most influential Delaware opinion” concerning corporate fiduciary law. See *supra* Part II.1.1. and Part IV.1.2.3.

sponsors' expectations.”³⁷⁷ On November 1, 1990, Giancarlo Parretti (“Parretti”)³⁷⁸—the major shareholder of Pathe Communications Corp. (PCC)—acquired MGM/UA Communications Co. for \$1.3 billion. Credit Lyonnais Bank Nederland (“CLBN”), as principal lender of the transaction, financed most of the acquisition price.³⁷⁹ Five months after the LBO, however, trade creditors of MGM-PCC (“MGM”) forced the company into

³⁷⁷ See *Credit Lyonnais*, *supra* note 34, at 1105. The leverage buyout—as incidentally noted by Chancellor Allen—was the “prototype transaction of the 1980s”, which was finalized to benefit shareholders at expense of other firm constituencies. Chancellor Allen also highlighted that when LBOs do not work, they can be of great damage to the corporate entity as a whole and potentially lead to bankruptcy. *See id.*

³⁷⁸ See *id.* Parretti started his movies business in the late 1980s through the acquisition of Cannon Group, Inc. (the predecessor of PCC). At the time, Cannon was experiencing deep financial troubles and Parretti’s equity infusion was vital to repay its indebtedness to CLBN, the company’s principal lender. From that moment, CLBN became Parretti’s principal business partner. By the 1989, Cannon had recovered almost one third of its existing debt and changed its name into PCC. It was then that Parretti started to develop his expansion plans and hired entertainment executive Alain Dodd to achieve this goal.

³⁷⁹ See *id.* at 1105-1106. The \$1.33 billion purchase price was paid through recourse to the following array of financing sources: (i) \$225 million-cash from distribution rights; (ii) \$400-million from CLBN financing as consideration for factoring rights on distributed licences and future payment obligations; (iii) \$160 million from CLBN bridge financing provided to PCC at closing; (iv) \$ 45 million from CLBN loan to Melia International N.V. (PCC’s parent company) and its controlling parent, Comfinance Holding Corp. (the original Parretti entity); (v) \$146 million from a Credit Lyonnais (CLBN parent bank) guaranteed loan granted by Sealion Corp. to PCC; (vi) \$89 million from Sasea (Melia's Swiss minority owner) loan; (vii) \$161 million from Italian financial institutions’ financing advanced on MGM’s credit; (viii) \$107 million from unknown sources).

Chapter 7, seeking repayment of unpaid trade bills.³⁸⁰ In the attempt of dismissing MGM's bankruptcy,³⁸¹ CLBN provided last resort financing conditioned on the right to appoint new management.³⁸² Threatened by bankruptcy, Parretti agreed to step down from his position as CEO of MGM and Chairman of the MGM's board. In mid-April 1991, after intense contracting among Alain Ladd (a PCC and MGM executive), the bank, and Parretti, CLBN agreed to provide additional \$145 million to MGM and Ladd agreed to become the company's new CEO. Although a Corporate Governance Agreement (CGA) limited the operational and decisional influence of Parretti over the corporation,³⁸³ "from the first moment, Parretti

³⁸⁰ Prior to the acquisition MGM had accumulated \$20 million in unpaid trade bills, because Parretti had ordered to slow down payment to trade creditors in order to minimize cash disbursements under a working capital credit facility prior to the MGM's closing. *Id.*, at 1111. Moreover, as Chancellor Allen observes, "[h]aving licensed away most of its films, factored the receivables resulting from such contracts, borrowed heavily and paid all the cash these transactions generated to Kerkorian [the former owner of MGM], MGM almost immediately found itself short of cash and cash producing assets." *Id.*

³⁸¹ The trade creditors' proceeding was particularly threatening because if not dismissed with sixty days would have resulted into the acceleration of MGM's \$300 million in outstanding bonds, bringing to the inevitable demise of the company. See *id.*, at 1116.

³⁸² This request by CLBN was motivated by the distrust that the bank had matured toward Parretti. Before the bankruptcy petition was filed, two senior executives of the bank had discovered that, among others, Parretti had (i) misrepresented borrowed funds as equity investments, (ii) \$100 million of the \$400 million in license contracts that MGM had factored at CLBN were actually unenforceable, (iii) and MGM's own credit had been surreptitiously used to finance part of MGM's acquisition. See *id.*, at 1111-1115.

³⁸³ The Corporate Governance Agreement (CGA) provided extensive powers to an executive committee, made up by Ladd and other members of the Ladd's team, while the

barely masked his efforts to continue to dominate and control the management of MGM.”³⁸⁴ Eventually, on June 14, 1991, Parretti called a special meeting of the MGM board. On that occasion the board adopted several resolutions, despite it had failed to meet the qualified majority requirement provided for by the CGA because Ladd and other senior executives did not attend the meeting.³⁸⁵ The core of the board’s deliberations consisted in giving Parretti powers to implement transactions in violation of the CGA. Forced by these events, CLBN determined that Parretti had breached the CGA and removed the PCC directors from the MGM board.³⁸⁶ The bank then filed a lawsuit under Section 225 of the Delaware General Corporation Law to have its newly elected board declared valid.³⁸⁷

While the primary legal issue in *Credit Lyonnais* was Parretti’s

MGM board only retained power to make extraordinary decisions. Parretti was entitled to select three members of the new MGM five-person board, but Ladd—as new chairman of the company—and his appointed Chief Operating Officer had substantial power over the board. Finally, in order to assure Parretti’s compliance with the CGA, a collateral Voting Trust Agreement provided that the voting rights of PCC and MGM shares would shift to CLBN in case of breach of the CGA. *Id.*, at 1117.

³⁸⁴ Soon after the execution of the GCA Parretti started a “battle” to regain material control of MGM. This battle began with a series of memos directed to Ladd and other MGM officers of MGM finalized to constrain their independency. *Id.*, at 1123.

³⁸⁵ *See id.*, at 1133-35.

³⁸⁶ *See supra* note 383.

³⁸⁷ *See id.*, at 1137.

illegitimate breach of the CGA,³⁸⁸ for the purpose of this discussion the relevant part of the case concerns the discussion of Parretti's allegation that both CLBN and Ladd breached the fiduciary duties they owed to him as MGM's controlling shareholder.³⁸⁹ In particular, Parretti claimed that Ladd was disloyal because he hindered the sale of certain MGM properties that would have allowed Parretti to regaining control over the company.³⁹⁰ In rejecting Parretti's claim, Chancellor Allen famously announced:

[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. ... the MGM board or its executive committee had an obligation to the

³⁸⁸ Parretti attacked the CGA based on a theory of conflict of laws. MGM had been operating under a 1987 SEC consent decree that required it to maintain a system of internal accounting controls. In addition, similar accounting control obligations for all public companies are mandatory under the Exchange Act § 13(b)(2). *See* Securities Exchange Act of 1934 § 13, 15 U.S.C.A. § 78m (West 1993)). Therefore, Parretti alleged that the CGA had divested PCC of the power to perform its legal duty to maintain such an effective control system in place. *See id.*, at 1132.

³⁸⁹ Technically, Parretti claimed that the duty ran to PCC, which held 98.5 % of MGM shares. But because Parretti controlled PCC, it is unharmed to refer to Parretti as the major MGM's stockholder.

³⁹⁰ *See id.*, at 1155-1157. Parretti further argued that CLBN breached fiduciary their duties by forcing MGM to enter into severance agreements with members of the Ladd's team that would be triggered had Parretti regained control over MGM. For Parretti, the payments made under the severance agreements "represented a tax upon the shareholders' exercise of their right to elect the board and thus constituted a breach of the duty of loyalty." *See id.*, at 1154.

community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.³⁹¹

In the by-now famous footnote accompanying the above passage of the ruling, Chancellor Allen added that “[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors.”³⁹² Combined with the hypothetical Chancellor Allen develops in the same footnote, these two statements offer the kernel of his view of fiduciary duties. For Allen, the beneficiary of directors’ fiduciary duties varies with the specific circumstances in which a corporate decision takes place, with a corporation’s financial conditions standing out as circumstances of primary importance. Under this view, insolvency is a context in which efficiency concerns require that shareholder primacy be altered in favor of a paradigm of extended obligations toward “the community of interests that sustained the corporations”.³⁹³ This does not mean, however, that the need to evaluate a corporation’s financial conditions for purposes of determining the beneficiary of fiduciary duties is restricted to insolvency. For the risk of shareholder

³⁹¹ *Id.*

³⁹² *Id.*, fn. 55.

³⁹³ Based on the elaboration of directors’ fiduciary duties, Chancellor Allen concluded that “[t]he Ladd management was not disloyal in not immediately facilitating whatever asset sales were in the financial best interest of the controlling stockholder.” *See id.*, at 1156.

opportunism that arises out of insolvency may likewise arise “in the vicinity of insolvency” and, potentially, even in solvent corporations. The discussion of Chancellor Allen’s hypothetical helps to better understand the reason for this.

3.2. *The Footnote of the Year*³⁹⁴

In support of his argument, Chancellor Allen provides a rigorous corporate finance hypothetical.³⁹⁵ He poses that there is a solvent corporation,³⁹⁶ which has debt for \$12 M owed to bondholders and a sole asset—a judgment for \$51 M against a solvent debtor. The judgment is on appeal and subject to modification or reversal. The appeal’s possible outcomes are 25% chance of affirmance, 70% chance of modification, and 5% chance of reversal. Hence the judgment’s expected value is \$15.55 M, while expected shareholder value is \$3.55 M. Then, the Chancellor poses that the corporation receives two offers to settle the judgment of respectively \$12.5 M and \$17.5 M. For ease of reference, Figure 1 below summarizes the

³⁹⁴ *"Footnote of the Year" Has Lawyers Wondering About the Zone of Insolvency*, 24 SEC. REG. & L. REP. 388 (1992).

³⁹⁵ *Credit Lyonnais*, *supra* note 34, fn. 55. The hypothetical in *Credit Lyonnais* is modeled on the facts of *In re Central Ice Cream Co.* See *In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987). For a comparative discussion of the two cases, see Douglas G. Baird & M. Todd Henderson, *Other’s People’s Money*, 60 STAN. L. REV. 1309, 1324-27 (2008).

³⁹⁶ The fact that the Chancellor refers to a “solvent corporation” highlights that the problem of excessive risk-taking is exacerbated in, but not exclusive of, insolvent corporations.

essential data of the example and the respective payoffs of shareholders and debtholders under each possible course of action.

Scenario	Prob.	Total Payoff	Payoff to Bondholders	Payoff to Equityholders
Affirm	25%	\$51.0	\$12.0	\$39.0
Modification	70%	\$4.0	\$4.0	\$0.0
Reversal	5%	\$0.0	\$0	\$0
Expected Value of Trial		\$15.55	\$5.8	\$9.75
\$12.5 million settlement		\$12.5	\$12.0	\$0.5
\$17.5 million settlement		\$17.5	\$12.0	\$5.5

Fig. 1. Credit Lyonnais –Expected Payoffs

As clearly shown by Fig. 1, the bondholders will prefer that the corporation go ahead with the settlement. This is because debt is always repaid in full when the corporation accepts one of the two settlement's offers. The shareholders, however, will always prefer the appeal because the 75% risk of modification or reversal on appeal is worth the 25% likelihood of earning \$9.75 M in case of affirmance. Instead, under the \$12.5 M offer, the shareholders would only receive an insignificant amount. And even under the \$17.5 M offer, they would not gain much after repaying the bondholders.

Given these possible actions and events (i.e., specific circumstances), Chancellor Allen explains what an efficient fiduciary duty paradigm would entail:

[I]f we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than \$ 15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.³⁹⁷

In light of this passage, two features emerge as central to the fiduciary paradigm articulated by Chancellor Allen. First, this paradigm is state-contingent, in the sense that it involves a conceptualization of fiduciary duty rules that varies with external states of the world. For example, insolvent corporations and highly leveraged corporations with risky projects provide two working examples of state-contingent corporate contexts in which it is desirable that fiduciary duties are attributed to creditors rather than shareholders. Second, the implementation of this paradigm envisions

³⁹⁷ *Credit Lyonnais*, *supra* note 34, at fn. 55.

fiduciary duties as formally running to the corporate entity. This is because the maximization of overall firm value is the ultimate purpose of having such duties in place. In practice, however, the identification of a particular constituency as the duties' state-contingent beneficiary is required to provide directors with a working proxy to better pursue overall welfare maximization.

3.3. *Credit Lyonnais' Fiduciary Paradigm*

The fiduciary paradigm articulated by Chancellor Allen in *Credit Lyonnais*, is clearly designed to incentivize Kaldor-Hicks directors' decisions. Indeed, while many commentators have criticized Chancellor Allen's opinion for being "against" the shareholder primacy model, the economic rationale underpinning *Credit Lyonnais* is perfectly compatible with this model as long as it meets Kaldor-Hicks efficiency criteria. To make a concrete example, had Parretti strategy been incremental rather than detrimental to the wealth creating capacity of MGM, Chancellor Allen's paradigm would have required Ladd to promote the sale of MGM assets.³⁹⁸

Viewed through this lens, *Credit Lyonnais* overcomes one of the major criticisms raised against the extension of fiduciary duty to creditors: namely, the unfeasibility of a fiduciary paradigm that requires directors to

³⁹⁸ Instead, Parretti was moved from the exclusive purpose of regaining control of MGM and thus the corporate directors well assumed that he could have undersold the corporate properties, causing a loss to the corporate entity as a whole. *See id.*, at 1155 ("observing that Parretti "needed to liquidate assets to raise capital. Ladd and his team could reasonably suspect that he might be inclined to accept fire-sale prices.").

“balance” the conflicting interests of shareholders and non-shareholders.³⁹⁹ It achieves this goal by providing directors with an economically grounded paradigm that, on the one hand, offers them material guidance in case of horizontal corporate conflicts and, on the other, is clear enough for investors to be able to anticipate its ex-post consequences and, possibly, contract around them.

At a first sight, this paradigm could appear to resemble the economic variant of the entity model (most notably, in the form of the “portfolio paradigm”).⁴⁰⁰ Unlike this variant, however, *Credit Lyonnais* does not envisage the corporation as a mere aggregation of financial claims, but as a “community of interests”.⁴⁰¹ This concept is much broader and potentially includes all the constituencies that have an economic interest in the corporation, such as non-voluntary creditors, employees, etc.⁴⁰² Similarly, one could argue that *Creditor Lyonnais* does not differ much from the TPT’s duty to maximize the joint welfare of all the individuals who make firm-specific

³⁹⁹ See *supra* text accompanying notes 275-279 (discussing multi-fiduciary counter-argument to the entity model).

⁴⁰⁰ See *supra* Part IV.2.2.1.

⁴⁰¹ See *Credit Lyonnais*, *supra* note 34, at 1156.

⁴⁰² Cf. A. Chaver & J.M. Fried, *Managers’ Fiduciary Duty Upon The Firms’ Insolvency Accounting For Performance Creditors*, 55 VAND. L. REV. 1813 (2002) (suggesting that the portfolio paradigm is conceptually flawed to the extent that it fails to consider that creditors as a corporate class includes both payment creditors and performance creditors (i.e., creditors who are owed contractual performance rather than cash)).

investments.⁴⁰³ However, while the TPT fails to provide working guidance to directors on how to solve horizontal corporate conflicts,⁴⁰⁴ *Credit Lyonnais* suggests that a feasible solution is to devise fiduciary duty rules that specifically take into account the contingencies in which these conflicts are more likely to arise.

3.4. A Critical Assessment

In light of the above, I consider Chancellor Allen's fiduciary model as a valuable attempt to move past ideology-driven conceptualizations of directors' fiduciary duties. This does not mean, however, that such a model cannot be improved. For one thing, the "vicinity of insolvency" trigger for the attribution of directors' duties to creditors lacks precision. Critics have largely criticized it as being, among others, "ill-defined",⁴⁰⁵ "regrettably ambiguous in its timing and scope",⁴⁰⁶ "too broad and thus without any clear significance",⁴⁰⁷ and "too difficult to evaluate".⁴⁰⁸ But this criticism loses much of its force when one considers the excessive risk-taking rationale

⁴⁰³ As a matter of fact, this is exactly the reading of the decision claimed by Blair and Stout. Indeed, they argue that "when viewed through the lens of the mediating hierarchy model, however, *Credit Lyonnais* makes sense". Blair & Stout, *supra* note 49, at 297.

⁴⁰⁴ See *supra* text accompanying notes 328-329.

⁴⁰⁵ Lipson, *supra* note 67, at 1210; Lin, *supra* note 334, at 1512; Jelisavcic, *supra* note 334, at 159 (adopting the equivalent expression of "poorly defined").

⁴⁰⁶ Nicholson, *supra* note 376, at 575.

⁴⁰⁷ Rao et al., *supra* note 334, at 62-64.

⁴⁰⁸ Schwarcz, *supra* note 334, at 672.

underpinning the attribution of fiduciary duties to creditors in these circumstances. Indeed, under this rationale state-contingent fiduciary to creditors are anchored by the firm's capital structure and available corporate projects rather than the "temporal dimension" of insolvency.

It is worth observing that some commentators have challenged the substantial impact of the problem of excessive risk-taking, suggesting that directors of financially distressed corporations would have incentives to act precisely in the opposite way than that described by Chancellor Allen.⁴⁰⁹ These commentators claim that a series of incentives would induce directors to refrain from excessively risky strategies, including contractual covenants⁴¹⁰

⁴⁰⁹ See, e.g., L. LoPucki and W. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large Publicly Held Companies*, U. Pa. L. R. 669, 684 (1993) ("[A] manager whose job and company are not immediately in jeopardy might prefer investments with risks that are lower than those preferred by the company's investors"); Barondes, *supra* note 334, at 101 (stating that "[t]he available economic evidence supports the notion that the "overinvestment" problem does not dominate the actions of directors of distressed corporations"); Rao et al., *supra* note 334, at 54 ("As this Article will demonstrate, in such circumstances [those of financially distressed firms], management has an incentive to serve the creditors' interests, perhaps at the expense of the shareholders, well before the firm is in bankruptcy").

⁴¹⁰ Debt contracts include covenants designed to restrict the company's range of actions in an attempt to ensure that it remains creditworthy. Most commonly, covenants include restrictions on liens ("negative pledge" causes), asset sales, leverage, and change of control. See, e.g., D.R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 135-36 (1989). Even very detailed covenants, however, cannot cover all possible future contingencies. Furthermore, "weak creditors", such as trade creditors, do not normally enjoy the protection of restrictive covenants. See W.W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667, 719.

and directors' interest in preserving their employment.⁴¹¹ The recent financial crisis, however, has provided conclusive evidence about the magnitude of the excessive risk-taking problem, proving that “[p]eople who should know better paint themselves into embarrassing corners” sometimes.⁴¹²

In fact, it is suggestive to observe that banks, as highly leveraged corporations, perfectly fit the hypothetical developed in *Credit Lyonnais*. Thus, one is left wondering whether a strict application of the *Credit Lyonnais* fiduciary paradigm could have played any role in constraining the risk taking incentives of bank executives, which have been unanimously recognized as a major factor leading to the crisis.⁴¹³ Unfortunately, *Credit Lyonnais* was applied strictly for only a relatively short period. Mainly because of the dominant influence of the (neo)contractarian ideology—which found support in a long-lasting positive economic cycle—subsequent Delaware rulings went back to a shareholder-centered conceptualization of fiduciary law.⁴¹⁴ The price paid for this was to finally learn—with the

⁴¹¹ See, e.g., LoPucki & Whitford, *supra* note 409, at 684.

⁴¹² Baird & Henderson, *supra* note 395, at 1312 (discussing, in general, the attempt by scholars to defend the shareholder primacy rule at all cost)

⁴¹³ See, e.g., L. A. Bebchuk & J. M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1916–17 (2010) (arguing that risk taking by bank directors and managers has been a crucial cause of the crisis); D. W. Diamond & R. G. Rajan, *The Credit Crisis: Conjectures About Causes and Remedies*, 99 AM. ECON. REV. (PAPERS & PROC.) 606, 607–08 (2009) (describing a “culture of excessive risk taking that had overtaken banks” and relating this culture to distorted risk incentives of top bank executives).

⁴¹⁴ In November 2004, the Delaware Court of Chancery issued a new, crucial

explosion of the crisis—that Chancellor Allen was right in warning corporate

opinion on directors' duties to creditors: *Production Resources Group, L.L.C. v. NCT Group, Inc.* See *Production Resources Group, L.L.C. v. NCT Group, Inc* 863 A.2d 772 (Del. Ch. 2004). The factual background of *Production Resources* involved a claim brought against the board of the NCT Group (NCT) by one of its creditors, who alleged that, among others, the board was liable for breach of fiduciary duties based on *Credit Lyonnais's* “vicinity of insolvency” paradigm. Rejecting the plaintiff’s argument the court also explicitly rejected any expansive interpretation of *Credit Lyonnais*. Chancellor Strine, the decision’s extensor, reaffirmed the principle that absent bad faith or self-dealing, both creditors of solvent corporations and corporations in the vicinity of insolvency have no standing to bring fiduciary duty claims against directors. See *id.*, at 787. For creditors have other legal tools at their disposal to protect their interests, including in the first place the contract. Therefore,

“[s]o long as the directors honor the legal obligations they owe to the company’s creditors in good faith, as fiduciaries they may pursue the course of action that they believe is best for the firm and its stockholders.... when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant.

Id. at 787-90.

In the 2007 case of *Ghewalla*, the Delaware Chancery Court was even more explicit in rejecting *Credit Lyonnais* and reaffirming shareholder-centered fiduciary principles:

[t]he directors of Delaware corporations have the legal responsibility to manage the business of a corporations for the benefit of its shareholder owners. [w]hen a solvent corporation is navigating in the zone of insolvency the focus for Delaware directors does not change.

N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

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America that the game played under shareholder primacy is not zero-sum.

VI. POLICY CONSIDERATIONS AND CONCLUDING REMARKS

This research has attempted to put some order in the debate on corporate fiduciary law in the United States. This debate has revolved around one fundamental question: “To whom directors owe fiduciary duties?” Yet, academic theories and legal doctrines alike have failed to provide a conclusive answer to this question. To the extent that some conclusions can be drawn, a negative result obtains from my research: the U.S. policy of corporate fiduciary duties has been contingent on the business cycle and the political view that from time to time has emerged as dominant. That is, the interpretation and enforcement of such duties have been largely influenced by ideological paradigms, which, on their turn, have historically been a product of underlying economic conditions.

On this view, the emergence of the contractarian instance parallels that of the libertarian ideals promoted by the Chicago School of free-market economists.⁴¹⁵ Libertarianism rests on the assumption of the second theorem of welfare in which any optimum can be supported as a decentralized equilibrium. Explained simply, for libertarians market mechanisms always lead to allocative efficiency. From a law and economics perspective, this

⁴¹⁵ See STOUT, *supra* note 7, at 18-19 (explicitly acknowledging the link between the Chicago School of economics and the contractarian view of the corporations and directors’ fiduciary duties.) Stout acutely observes that “[t]o tenure-seeking law professor, the Chicago School’s application of economic theory to corporate law lent an attractive patina of scientific rigor to the shareholders side of the longstanding ‘shareholders versus society’ and ‘shareholders versus stakeholders’ dispute.”)

ideal is grounded on the property of Coasean bargaining, under which parties can always improve their initial condition through efficient contracting.⁴¹⁶ Consequentially, libertarians conceive of the legal system as ancillary to markets and government action as limited to the enforcement of contracts. Even from this brief description, the strong ideological imprint of libertarianism is apparent.⁴¹⁷ For libertarians, economic agents always do better than the government in defining their rights and duties, no matter how complex the transactional environment is.⁴¹⁸

The libertarian ideology reached its apotheosis in the 1980s, during the Regan presidency. In a sense, Regan's economic policy (or Reaganomics)—based on lower taxes and less state intervention—put libertarianism into practice. As concerns specifically corporate matters,

⁴¹⁶ The contracting part of the Coase Theorem states that parties will find it efficient to contract around externalities in order to reach a Pareto improvement. This implies that when transaction costs are moderate, the allocation of property rights as enforced through regulation is indifferent because parties will always be able to allocate rights efficiently by contract. *See Coase, supra* note 19.

⁴¹⁷ Given the influence exercised by libertarians on contractarians, it is self evident that libertarian ideology implies contractarian ideology as a direct consequence. *See STOUT, supra* note 7, at 19. *See also supra* note 23 (providing sources on the underpinning philosophical justification of this argument).

⁴¹⁸ The seminal work is A. Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776) (using the metaphor of the invisible hand to explain how uncoordinated markets reach efficiency). Analytically, Smith's invisible hand translates into the more sophisticated metaphor of the Walrasian auctioneer, according to which markets would always be in equilibrium because any disequilibrium would immediately readjust to another equilibrium. *See generally, MAS-COLELL ET AL., supra* note 19, at 620-624.

Reaganomics embraced the view of shareholders as benevolent mass capitalists and managers as an elite selected through competitive market mechanisms. This approach fully internalizes the libertarian ideal that external governance mechanisms (i.e., the market for corporate control) provide the primary mechanisms to improve corporate efficiency,⁴¹⁹ while internal governance mechanisms (i.e., corporate fiduciary duties) only play a residual function.

With the economic crisis of the late 1980s, the trend reversed. In particular, after the 1987 crash, corporate America came to realize that capital markets could destroy welfare. Corporate scholars began to acknowledge that efficiency might not always be the equilibrium outcome under *laissez faire* economic policies. Indeed, the magnitude of the economic losses of the time largely exceeded the gains accumulated during prior years—especially if one considered the losses experienced by non-shareholders (i.e., bondholders

⁴¹⁹ External governance mechanisms have traditionally been identified with the sole market for corporate control, that is, the control and economic rights that arise from the trading of equity interests. See H. G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965). In recent years, however, corporate law scholars have begun to acknowledge that non-equity holders (i.e., debtholders and holders of hybrid financial instruments) also exercise external control over the corporations in specified circumstances, such as nearly-insolvent corporations and the venture capital context. See, e.g., D. G. Baird & R. K. Rasmussen, Essay, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1217 (2006). Note that this is consistent with this research's argument that in some circumstances creditors might be even more interested than shareholders in firm performance and therefore are likely to serve as a better proxy for overall welfare maximization.

and employees) during the takeover era. With the concerns brought about by these events, the egalitarian perspective of communitarians began to reach popular consensus. This perspective challenged the normative conclusions of libertarianism by reclaiming a role for non-market institutions (i.e., centralized mechanisms), seen as essential to mitigate the externalities engendered by private contracting. Under this view restricting the space of contracts is instrumental to redirect the actions of economic agents toward more desirable equilibria. Therefore, communitarians refuse the idea that Coasean bargaining always produces efficient outcomes. They support instead the centralized dimension of the Coase theorem, which holds that the reallocation of legal entitlements is necessary to pursue efficiency in a world of high transaction cost.⁴²⁰ From a corporate fiduciary perspective, the kernel of the communitarian proposal consists in enlarging the scope of corporate fiduciary duties and delegating the resolution of corporate conflicts to the judicial system.

Nonetheless, the communitarian proposal also turns out to be strongly ideological. Communitarians ground their social model on the undisputed assumption that institutions are always superior coordination mechanisms to market—exactly the opposite of what contractarians advocate. As applied to the corporate fiduciary context, this ideology envisions directors as disinterested mediators of multiple corporate instances who pledge their personal liability to signal their impartiality. In other terms, directors are

⁴²⁰ See *supra* note 19.

viewed almost as social planners, charged with the task of redistributing resources among corporate participants to the end of maximizing social welfare. However, communitarians fail to provide clear indications on how to operationalize this fiduciary duty model. That is, faced with concrete implementation issues, this model emerges as unpractical and difficult to administer.

The vagueness affecting the communitarians' fiduciary duty model produced a new contractarian "offensive" during the economic boom of the Clinton era. Neo-contractarians dismantled the communitarian model by exposing the so-called *too-many master argument*. Pursuant to this argument, when directors are required to balance the interests of all corporate participants, the administration of fiduciary duties becomes so difficult that they practically become no duties at all. Hence, it may become easier for directors to justify self-interested conduct on the basis of the alleged benefits accruing to one or the other corporate constituency.

Since the Clinton years, the neo-contractarian paradigm has come to be regarded as the "orthodox" view of U.S. corporate fiduciary duties—more, I dare to say, because of the ambiguity of the communitarian proposal than the inherent validity of the contractarians' normative propositions. Under these propositions, a bright line is drawn between the remedies respectively available to shareholders and non-shareholders to solve horizontal corporate conflicts. Neo-contractarians view such conflicts as the result of contractual

incompleteness issues (i.e., costs).⁴²¹ Indeed, if corporate actors were able to specify ex-ante “payoff-relevant actions for every possible state of the world and the payoffs for these actions”,⁴²² there would be no room for corporate conflicts of any sort. For neo-contractarians, however, the contractual incompleteness costs faced by common shareholders, as residual claimants, is much more severe than that faced by other capital providers.⁴²³ In order to fully protect their interests, shareholders should contractually specify any directors’ action, since any such action has an impact on shareholder value (i.e., corporate asset value). But because the corporate decision-making process is a continuous process, it is technologically unfeasible to control any directorial decision by contract.⁴²⁴

⁴²¹ Among others, incomplete contract costs include (i) *bounded rationality costs*—the costs arising “in a complex and highly unpredictable world, [because] it is hard for people to *think* far ahead and to plan for all the various contingencies that may arise”; (ii) *transaction costs*—the costs arising because “even if individual plans can be made, it is hard for the contracting parties to *negotiate* about these plans” and (iii) *non verifiability costs*,—the costs arising because

even if the parties can plan and negotiate about the future, it may be very difficult for them to *write* their plans down in such a way that, in the event of a dispute, an outside authority—a court, say—can figure out what these plans mean and enforce them.

See O. HART, *FIRMS CONTRACTS AND FINANCIAL STRUCTURES* 23 (1995).

⁴²² A. Schwartz, *Incomplete Contracts*, in 2 *THE NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS* 277 (1998).

⁴²³ See *supra* Part IV.1.1.3.

⁴²⁴ See Jensen & Meckling, *supra* note 10, at 338.

Other corporate constituencies, instead, are not concerned with overall firm performance, but only with the fulfillment of the obligations they have bargained for (e.g., for creditors—the repayment of interest and principal.) Hence, they only care about a subset of directors' decisions⁴²⁵ and can therefore achieve full protection of their interests by contract.⁴²⁶ Therefore, for neo-contractarians the protection of corporate law and corporate fiduciary duties should be exclusively reserved to shareholders. Non-shareholder interests, instead, should be protected at contract law. But this solution fails to consider that the contract may be as inadequate an instrument to protect the interests' of other corporate constituencies as the shareholders' in some circumstances. After all, if one brings the incomplete contract approach to the extreme, no contract can foresee and specify all possible contingencies when a relationship is long-term—as corporate relationships are. This implies that other corporate constituencies may need additional protections to secure their investment expectations—including the acquisition of positive control rights, the appointment of board designees, and even the attribution of corporate fiduciary duties.⁴²⁷

In this light, the ultimate problem underpinning corporate fiduciary

⁴²⁵ See TIROLE, *supra* note 97, at 47.

⁴²⁶ See Macey, *supra* note 212, at 36 (arguing that corporate constituencies other than shareholders can “protect themselves against virtually any kind of managerial opportunism by retaining negative control over the firm’s operations.”)

⁴²⁷ See S. Sepe, *Divided Loyalty*, University of Arizona James E. Rogers College of Law working paper (on file with author).

law is how to reconcile the ex-ante efficiency of the contractarian model with the ex-post efficiency of the communitarian model. The former model promotes ex-ante welfare by providing contracting parties with clear parameters as to future corporate actions. Indeed, the operational mandate of the shareholder primacy rule offers the advantage of eliminating uncertainty on directors' ex-post decisions. This safety, however, may come at the expense of the production of negative externalities, which parties may be unable to fully internalize by contract. In contrast, the communitarian model achieves ex-post efficiency by enabling directors to efficiently “complete” corporate contracts as new information materializes.⁴²⁸ But while this approach is alluring from a social planning point of view, it may raise ex-ante uncertainty. This is because this model would potentially enable directors to trump not only existing fiduciary principles, but also explicit contractual provisions. This uncertainty would most likely result in an increase in the participation costs of the various corporate stakeholders—first of all, an increase in the cost of capital—with the result of reducing aggregate welfare.⁴²⁹

⁴²⁸ Mechanism design studies how to elicit information by defining a game or mechanism (in applied terms, rules, institution and incentives) that induces the agent to truthfully reveal their information so that desirable social goals are implemented. See MAS-COLELL ET AL., *supra* note 19, at 857-925.

⁴²⁹ Potentially, these costs could be so high as to violate the firm's *participation constraint* (or *individual rationality constraint*): the property of optimal agency contracts that is satisfied when the contract leaves all participants as well off as they would have been if they had not participated. See B. SALANIÉ, *THE ECONOMICS OF CONTRACTS* 122 (2d ed.

An example may be useful to clarify the consequences that ex-ante uncertainty may produce on corporate relationships. Consider the case of an entrepreneur that has assets equal to A and needs additional capital for an amount equal to K to implement a project. The project can yield a gross return equal to R with probability p and 0 with the complementary probability (i.e., $(1 - p)$). The implementation of the project requires labor force for a cost equal to L . Assume also the following:

- (i) The entrepreneur wants to raise equity to finance the project;
- (ii) The equity market is competitive;
- (iii) Both equity and labor providers are paid once the project is completed to the extent that cash flows will be available;
- (iv) The project gets financed because it has a positive net present value: $p[R(K + A) - L] - K - A > 0$.

Under this setting in competitive financial markets, in exchange for K the equity holders would ask a fraction of the corporation equal to α , which, in equilibrium, is determined by the following condition: $\alpha = \frac{K+A}{p[R(K+A)-L]}$. Assume now that at an intermediate stage of production, the directors—under the pressure of unions or the incumbent political power—have to decide whether to increase the cost of labor from L to θL , with $\theta > 1$.⁴³⁰ If they do that with some positive probability $\pi \in (0,1]$, they will decrease the yield of

2005).

⁴³⁰ Under a fiduciary system that obligates directors to consider the interest of labor, such as the German system, this is a realistic assumption. *See supra* note 5.

the equity capital. But if the equity providers anticipate this possibility, they will increase the cost of capital by requiring a larger stake (α^*) of the firm. More specifically this stake will be determined by the following equation: $\alpha^* = (1 - \pi)\alpha + \pi\alpha^{high}$, where $\alpha^{high} = \frac{K+A}{p[R(K+A)-\theta L]} > \alpha$.⁴³¹ Note that the problem is not merely distributional between capital and labor. Instead, it will concern allocative efficiency whenever prospective equity providers have some risk aversion or misestimate (i.e., overestimate) π and, as a result, discount the cost of capital more than it would be required for being compensated for possible ex-post wealth expropriations.

This simple example can be generalized to any kind of horizontal conflict between shareholders and other corporate constituencies. This is because ex-ante uncertainty about future distributional outcomes may always lead to the reduction of overall welfare—no matter which the involved horizontal corporate relationship is. On this view, the most challenging task for future research is devising a normative paradigm that enables directors to make ex post efficient decisions, while at the same time minimizing the overall cost of capital for corporations (i.e., ex-ante uncertainty). To this end, I argue that selective judicial intervention would be desirable. This intervention should provide corporate actors with a taxonomy of state-contingent fiduciary duties. This taxonomy would be useful, on the one hand, to guide directors' ex-post completion of corporate contracts. On the

⁴³¹ Analytically, that increasing the cost of labor increases also the cost of equity capital is immediate from the fact that $\frac{d\alpha}{dL} > 0$.

other hand, it would enable corporate participants (i.e., both shareholder and non-shareholder constituencies) to know ex-ante—and, therefore, properly discount—the effects of such decisions on their investment expectations. For example, in this research I have extensively discussed what I termed the creditor variant of the corporate fiduciary paradigm.⁴³² That variant challenges the validity of the shareholder primary rule as an operational guidepost for directors' decisions upon specified circumstances. To this extent, it redefines the boundaries of this rule, suggesting the possibility that alternative rules (i.e., a creditor primacy rule) may be desirable depending on state-contingent conditions. The much-celebrated 1991 decision of Chancellor Allen in *Credit Lyonnais* moved further along this path,⁴³³ suggesting that fiduciary duties should shift to creditors “in the vicinity of insolvency” and, potentially, even in solvent corporation.⁴³⁴

Forging ahead in this direction, I suggest that courts should generalize the creditor variant approach by identifying circumstances in which negative externalities are more likely to arise. Then, they should prescribe specific fiduciary conducts for such circumstances. A mindset for non-ideological inquiry would be the preliminary requirement for the success of this selective intervention by courts. In practice, courts should abandon the ideological approaches to corporate fiduciary duties of the past and move to the

⁴³² See *supra* Part V.

⁴³³ See *Credit Lyonnais*, *supra* note 34.

⁴³⁴ See *id.*, at 1155.

identification of clear parameters (or tests) to articulate such duties. For instance, they should start investigating under what circumstances, if any, directors would be allowed to keep a factory plant in place despite potential increases in the cost of capital. Along the same line, it would be desirable that they addressed fiduciary issues in situations where directors have private information on the potential risks that may arise from firm activity for the surrounding community, individual workers, or the public at large. To offer a more tangible example, in the aftermath of the crisis, it emerged that most bank directors (i.e., executive directors) were aware of the huge risks associated with investments in the remunerative subprime market.⁴³⁵ Thus, whether fiduciary law could have played any role in limiting the disastrous effects that reckless directorial decisions had on U.S. taxpayers is a non-trivial normative question.⁴³⁶

⁴³⁵ See generally STIGLITZ, SUPRA NOTE 7, at 154 (generally blaming the crisis on “poor corporate governance”). The by now infamous word of Chuck Prince, Citigroup’s former CEO, are paradigmatic of the reckless attitude of bank board members before the crisis. “When the music stops in terms of liquidity, things will get complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” See Michiyo Nakamoto & David Wighton, *Citigroup CEO Stays Bullish on Buy-Outs*, FIN. TIMES, Jul. 9, 2007, available at <http://www.ft.com/intl/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz1VSMRJIQb>. Chuck Prince notably resigned from his position as Citigroup CEO only four months after this declaration, due to the major losses Citigroup experienced in the mortgage-backed securities business. See *Statement from Citigroup on the Resignation of C.E.O. Charles O. Prince III*, N.Y. TIMES, Nov. 5, 2007, available at <http://www.nytimes.com/2007/11/05/business/05citi-text.html> (last visited on Dec. 10, 2011).

⁴³⁶ It is worth observing that one the strongest supporter of the shareholder primacy

Corporate actors need certainty in order to optimize actions along a strategic dynamic path. But certainty should not come at the expense of ex-post inefficiency. Corporate fiduciary law should be rethought so to provide a solution to the tradeoff between these two instances. My suggestion that courts should devise state-contingent fiduciary rules is a first attempt to move toward this direction.

rule, Professor Macey has coauthored an article in which he proposes that

the duties and obligations of corporate officers and directors should be expanded in the special case of banks. Specifically, directors and officers of banks should be charged with a heightened duty to ensure the safety and soundness of these enterprises. Their duties should not run exclusively to shareholders. Our variant calls for bank directors to expand the scope of their fiduciary duties beyond shareholders to include creditors. In particular, we call on bank directors to take solvency risk explicitly and systematically into account when making decisions, or else face personal liability for failure to do so.

J. R. Macey & M. O'Hara, *The Corporate Governance of Banks*, *ECON. POL'Y REV.*, April 2003, at 91.

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