**Fiduciary Law and Entrepreneurial Action**

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**PRELIMINARY AND INCOMPLETE DRAFT**

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Introduction

When evaluating claims involving the duty of loyalty in a business organization, modern judges in the United States do something routinely that would have seemed improper to judges a century ago, something that still astonishes judges and commentators in other countries. In deciding whether business managers or other fiduciaries have breached the duty of loyalty, modern judges in the U.S. evaluate the substantive fairness of challenged transactions, and if the transactions are deemed to be fair, the fiduciaries are not liable.[[2]](#footnote-2) Substantive fairness review offers an alternative path to transactional validity not available in most countries, reflecting a fundamental policy in the U.S. of promoting action, sometimes even at the expense of vulnerable parties.

The preferred path to transactional validity for conflict transactions involves *ex ante* disclosure of relevant conflicts and approvals by disinterested decisionmakers, either co-fiduciaries or the beneficiaries of fiduciary duties. When contemplating a conflict transaction, most fiduciaries in the U.S. attempt to follow this path, but it is not free from litigation risk, as beneficiaries frequently challenge the appropriateness of the disclosures or the quality of the approvals. Faced with this uncertainty, fiduciaries may obtain an extra measure of comfort from the possibility of substantive fairness review.

Outside the U.S., *ex ante* disclosure and approval is not only the preferred path to transactional validity for conflict transactions, but generally the exclusive path. Like the U.S., other common law countries rely heavily on fiduciary law to regulate conflict transactions, but unapproved action in the face of conflict is generally considered a breach of the duty of loyalty, even if the action is substantively fair. Civil law countries rely less on fiduciary law to regulate conflict transactions, but the rules of engagement are quite similar to these common law jurisdictions, specifying the need for disclosure and approval in advance. In both common law and civil law countries, the usual remedy for unapproved conflict transactions is avoidance.

The regulation of conflict transactions in most common law countries and in civil law systems reflects a deep skepticism of conflict transactions.[[3]](#footnote-3) The voidability regime holds that fiduciaries should not gain from conflict transactions, unless beneficiaries expressly approve the gain. This same skepticism of conflict transactions appears in trust law and other trust-like circumstances in the U.S. In the context of business organizations, however, concerns about self-interested actions by fiduciaries are counterbalanced to some extent by a preference for action.

Courts and commentators on business organizations law generally miss this comparison because substantive fairness review is embedded within the more expansive “entire fairness” standard of review, which is usually compared to the more lenient business judgment rule. The sophisticated judicial opinions of the Delaware Supreme Court and the Delaware Court of Chancery, which are widely cited and followed by courts in other jurisdictions,[[4]](#footnote-4) refer to the entire fairness standard as “exacting,”[[5]](#footnote-5) “rigorous,”[[6]](#footnote-6) “onerous,”[[7]](#footnote-7) or “demanding,”[[8]](#footnote-8) but all of these adjectives are inspired by reference to the business judgment rule, which is not available for conflict transactions. In evaluating the comparative effect of substantive fairness review on economic action, the more appropriate baseline for comparison is not the business judgment rule, but the voidability regime embraced by almost all countries outside the U.S.

Developed largely in cases involving large corporations, substantive fairness review may be particularly helpful to entrepreneurial startups, which rely heavily on conflict transactions. In this setting, conflicts of interest often arise from a desire to further the interests of the firm, rather than a desire to engage in self dealing. Consider, for example, the venture capitalist who is invested in a number of firms in a single industry. Surrounded by a web of conflicts, the venture capitalist would tend to be cautious in most legal systems, but the venture capitalist is emboldened by conflict regulation in the U.S.

 The preference for action is easy to perceive when comparing substantive fairness review to voidability – after all, substantive fairness review offers another bite at the apple that is simply not available in the voidability regime[[9]](#footnote-9) – but the motivation for action may come at a cost to some beneficiaries. For example, *ex post* review of conflicted transactions allows fiduciaries to postpone the ultimate resolution of difficult structural or pricing issues, and, if a transaction is never challenged, the fiduciary may never need to fully grapple with these issues. Even if a transaction is challenged, judges are not well equipped to evaluate substantive fairness, and, in the face of uncertainty, they often defer to outcomes determined by the parties. Even when judges find unfairness, the remedy is the difference between the fair value determined by the court and the value actually conveyed, so a conflicted fiduciary loses little from being aggressive on price and pressing forward.[[10]](#footnote-10)

Most commentators on substantive fairness review do not recognize U.S. exceptionalism in this area, and those who do generally describe this development as an erosion of the fiduciary principle.[[11]](#footnote-11) Powerful fiduciaries are portrayed as rapacious opportunists, taking advantage of vulnerable counterparties. This Article takes a contrary position, arguing that the content of fiduciary law in the U.S. balances the desire to protect vulnerable parties with a fundamental policy of promoting entrepreneurial action. Substantive fairness review of conflict transactions is part of the institutional configuration that facilitates entrepreneurial action.[[12]](#footnote-12)

In Part I defines “entrepreneurial action” for purposes of this paper in terms of startup formation. Part II describes the inevitability of conflict transactions in entrepreneurial firms and offers a simple typology of conflict transactions for closer analysis. Part III then provides this closer analysis, examining four regulatory strategies for conflict transactions: prohibition, disclosure and waiver, adminstrative approval, and substantive fairness review. Part IV connects substantive fairness review with the policy of promoting entrepreneurial action.

1. Entrepreneurial Action

Entrepreneurs challenge incumbency,[[13]](#footnote-13) and, contrary to popular perception, entrepreneurs rarely act alone.[[14]](#footnote-14) Even “sole proprietorships” rely on many people, including customers, financiers, suppliers, production or manufacturing personnel, marketing or sales personnel, and financial or accounting personnel. The entrepreneur can attempt to forge all of these relationships through independent contracts, but at some moment in the development of the business, it often makes economic sense to form a business organization, or “firm,” by taking on investors and employees.[[15]](#footnote-15) The formation of a firm gives rise to fiduciary obligations,[[16]](#footnote-16) inspiring our examination of the heretofore largely unexplored connection between fiduciary law and entrepreneurial action.

Entrepreneurial action occurs when an entrepreneurial team uses existing resources (including natural resources, financial resources, intellectual property, etc.) to exploit an opportunity.[[17]](#footnote-17) Entrepreneurial action may be manifest in various ways.[[18]](#footnote-18) For example, Joseph Schumpeter offered a typology of five forms of entrepreneurial opportunities – new goods, new methods of production, new geographical markets, new raw materials, and new ways of organizing – and the exploitation of any of these would constitute entrepreneurial action.[[19]](#footnote-19)

Generally speaking, however, researchers equate entrepreneurship with startup activity, even though this measure of entrepreneurial action captures only a fraction of what might fall within the term “entrepreneurial action,” as defined above.[[20]](#footnote-20) While in most instances we would prefer a broader measure of entrepreneurship, in this Article we are concerned with ways in which fiduciary law relates to entrepreneurial action. Focusing on startup formation offers meaningful insights for such an inquiry because the formation of a startup represents an early step in the process of taking entrepreneurial action, and startups are abundant with fiduciary obligations.

The issue that motivates this Article is whether fiduciary law facilitates or impedes entrepreneurial action, but establishing causation of this sort is problematic. One basic obstacle is defining the dependant variable. There are at least two ways one can conceive of a business startup, both of which are reflected in the most important datasets in entrepreneurship research. The World Bank Entrepreneurship Database measures startup activity in 139 countries by reference to formal business registrations, which includes only “newly registered companies with limited liability (or its equivalent).”[[21]](#footnote-21) Thus, partnerships and sole proprietorships are excluded. By contrast the Global Entrepreneurship Monitor (“GEM”) relies on a survey to measure business formations, even when those do not include formal business registrations.[[22]](#footnote-22) Perhaps not surprisingly, studies relying on these datasets sometimes lead to contradictory results, as one dataset measures “rates of entry into the formal economy” while the other measures “entrepreneurial intent.”[[23]](#footnote-23) Given the difference in focus, it is not surprising that the World Bank dataset shows significantly higher levels of entrepreneurship in developed countries, while the GEM dataset reports significantly higher levels of entrepreneurship in developing countries.

Given the difficulties in isolating and measuring the effect of fiduciary law, we approach the task of examining the connection between fiduciary law and entrepreneurial action from the other direction. Our thesis is that the fundamental policy in U.S. law of promoting entrepreneurial action has influenced the structure of fiduciary law.[[24]](#footnote-24) In the argument that follows, we describe the structure of conflict regulation in various jurisdictions, establishing the uniqueness of the American approach, which seems designed to encourage entrepreneurial action.

1. Conflict Transactions

Firms are legal instruments that grease the wheels of entrepreneurial action by defining the roles of the various participants.[[25]](#footnote-25) In this Article, we are particularly interested in circumstances when one participant acts on behalf of the firm or another participant in the firm. Although these circumstances exist in a wide variety a legal forms, we focus most of our attention on conflicts involving equity owners of the most common business organizations. In the corporate context, these are conflicts among shareholders, but we also include conflicts among members of limited liability companies, and conflicts among partners. These conflicts are sometimes mediated by a board of directors or comparable body of centralized managers, so conflicts between the central manager and the equity owners are also governed by conflict regulation.[[26]](#footnote-26) Scholars in all disciplines conceptualize these interactions as “agency relationships,”[[27]](#footnote-27) analogizing to the law of agency.[[28]](#footnote-28)

1. Inevitability of Conflict

Implicit in the representative structure of an agency relationship is a grant of discretion by the principal to the agent. Thus, embedded within the decision to create a firm is a (sometimes unconscious) decision to yield some control to other participants in the firm and to accept responsibility for their actions.[[29]](#footnote-29) Although the agent’s discretion creates the potential for conflict between the principal and the agent, the grant of discretion is useful to the principal because it allows the principal to manage uncertainty. Therefore, the agent’s discretion “is not a bug, it’s a feature.”[[30]](#footnote-30)

Legal rules and practices can facilitate the creation of agency relationships by constraining the agent’s discretion. Regulations expressly define the terms under which agency relationships are formed and establish default rules to govern interactions within those relationships, as well as interactions between agents and third parties.[[31]](#footnote-31) In addition, the parties to an agency relationship may enter into contracts overriding the regulatory default rules or lending clarity to their execution. Even after accounting for regulatory and contractual constraints, the agent will necessarily retain some residual discretion. This discretion is the incubator for conflict transactions.

Conflict transactions are viewed with varying degrees of skepticism by courts and commentators, but all agree that some conflict transactions are inevitable.[[32]](#footnote-32) In addition, many conflict transactions are valuable to the companies,[[33]](#footnote-33) especially small firms.[[34]](#footnote-34) And in a startup environment like Silicon Valley, conflict transactions may be essential to the health of the ecosystem.[[35]](#footnote-35)

1. Displacement and Advancement

Conflicts between principals and agents can be classified along several dimensions. The most common scheme distinguishes broadly between issues of loyalty and performance, with the former being regulated by fiduciary law and the latter primarily by contract law or the duty of care.[[36]](#footnote-36) Courts and commentators in Commonwealth jurisdictions sometimes distinguish conflict of duty and interest, one the one hand, and conflict of duty and duty, on the other.[[37]](#footnote-37) Conflicts of duty and interest include traditional self-dealing (the purchase or sale of services or assets by related parties), minority oppression,[[38]](#footnote-38) appropriation of company opportunities, and various forms of misconduct collected under the label “tunneling.”[[39]](#footnote-39) Conflicts of duty and duty occur when a fiduciary is serving heterogeneous beneficiaries or when fiduciary duty conflicts with a non-fiduciary duty, such as a contractual duty.[[40]](#footnote-40) This Article focuses on issues of loyalty representing conflicts of duty and interest, but within this set of conflicts is a further distinction that is revealed by approaching the subject from the perspective of entrepreneurial action, namely, the distinction between *displacement* and *advancement*.

Displacement occurs when a fiduciary appropriates something of value that belongs to a beneficiary, including property, profits, or opportunities. The key feature of a displacement transaction is that the fiduciary merely replaces the beneficiary as the recipient of value. The fiduciary’s appropriation does not, in itself, create additional value. By contrast advancement occurs when a fiduciary engages in a transaction that otherwise might not occur, but has the potential to create value for the beneficiary. Classic self-dealing transactions have this feature.

The dichotomy between displacement and advancement is reflected in what Commonwealth lawyers describe as two pillars of conflict regulation, the “no-profit rule” and the “no-conflict rule.”[[41]](#footnote-41) Although these two rules are sometimes portrayed as operating together, they actually represent alternative tracks that a beneficiary may pursue against a conflicted fiduciary, with different judicial standards and remedies, explored in the next section.

1. Conflict Regulation

Courts review challenges under the no-profit rule by reference to the logic of property rights – determining whether the property, profit, or opportunity belongs the fiduciary or the beneficiary – and an aggrieved beneficiary may recover any gains of the fiduciary in receiving a disgorgement remedy. By contrast courts review challenges under the no-conflict rule by reference to the logic of tort action – asking whether the actions of the fiduciary are wrongful vis-à-vis the beneficiary – and an aggrieved beneficiary may obtain a compensatory remedy, either through avoidance (recission) of the transaction or, in some cases in the U.S., by monetary damages equal to the difference between the fair value of the transaction and the negotiated value of the transaction. As explained below, these differences in treatment have much different incentive effects with regard to entrepreneurial action.

1. Rationale For Conflict Regulation

In any business organization, an ideal decision maker is competent, informed, and disinterested. Generally speaking, courts defer to decision makers who possess these attributes, even when their decisions seem unwise in hindsight. When a decision maker is incompetent, legal rules usually place the burden of any harm from the decision on those who have associated themselves with the decision maker, rather than requiring the decision maker to compensate others for mistaken judgments. When a decision maker is uninformed or misinformed, courts may be more sympathetic to claims by those who are harmed, but only if the lack of information gathering by the decision maker was self-interested. Conflicts of interest introduce the possibility of bias, and legal rules rarely give decision makers the benefit of the doubt when they confront a conflict of interest and duty.[[42]](#footnote-42)

The onus is usually on decision makers to avoid placing themselves in positions of conflict.[[43]](#footnote-43)

1. Conflict Regulation Four Ways

In his decision in *Meinhard v. Salmon*, Justice Cardozo famously described the fiduciary obligation of a joint venturer in terms of unselfishness.[[44]](#footnote-44) Similar statements by judges can be found in other jurisdictions.[[45]](#footnote-45) Although many commentators have taken these statements at face value,[[46]](#footnote-46) the duty of unselfishness is largely a rhetorical flourish, not a substantive standard, at least in the context of startup business organizations.[[47]](#footnote-47) In circumstances where the fiduciary is not only an agent but also a principal, personal considerations necessarily enter into the decision space.[[48]](#footnote-48)

Lawmakers and courts are tasked with sifting conflict transactions, permitting the beneficial transactions to proceed and halting or, if possible, undoing the destructive transactions. Different national legal and market systems have developed somewhat different approaches to dealing with potential conflicts.[[49]](#footnote-49) These approaches are of four ideal types: (1) prohibition of conflict transactions, (2) tolerance of conflict transactions, subject to prior disclosure and approval; (3) tolerance of conflict transactions, subject to prior administrative approval; and (4) tolerance of conflict transactions, subject to evaluation for substantive fairness.[[50]](#footnote-50) Many jurisdictions distinguish various types of conflict transactions, employing a variety of regulatory strategies depending on the perceived severity of the conflict.[[51]](#footnote-51) We explore each of the ideal type of conflict regulation below.

* 1. Prohibition

U.S. law does not prohibit conflict transactions in business organizations, invalidating such transactions only if they are substantively unfair. Many jurisdictions outside the U.S., particularly civil law countries, simply prohibit certain conflict transactions, such as competition[[52]](#footnote-52) or loans between a company and its officers. This sort of blanket prohibition typically is justified on the ground that the specified transactions are simply too fraught.[[53]](#footnote-53) While prohibitions of this sort ease the burden of *ex post* judicial or administrative review, they sacrifice any potential benefits to the business organizations from the specified conflict transactions. More important for present purposes is the rule – generally applicable outside the U.S. – that all conflict transactions are voidable without regard to fairness. As explained below, transactions typically can be clensed of the taint of conflict via prior approval, but the voidability regime effectively prohibits conflict transactions.

In a widely cited and highly influential article, Harold Marsh concluded that conflict transactions between a corporation and a director were prohibited by the common law in the U.S., meaning that “any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction.”[[54]](#footnote-54) According to Marsh, the taint of conflict could not be clensed by the approval of disinterested directors, as “the corporation was entitled to the unprejudiced judgment and advice of all of its directors.”[[55]](#footnote-55) Perhaps most surprisingly, Marsh claimed that nineteenth century U.S. courts took claims of structural bias seriously,[[56]](#footnote-56) reasoning, “The moment the directors permit one or more of their number to deal with the property of the stockholders, they surrender their own independence and self control.”[[57]](#footnote-57) As a result, Marsh concluded, “This principle, absolutely inhibiting contracts between a corporation and its directors or any of them, appeared to be impregnable in 1880.”[[58]](#footnote-58)

Within the next 30 years, Marsh argued, the general rule had changed in many jurisdictions, and conflict transactions were held to be valid, if challenged, when approved by disinterested directors[[59]](#footnote-59) and found by a court to be substantively fair.[[60]](#footnote-60) In Marsh’s view, this move toward increased tolerance of conflict transactions was a lamentable degradation of the fiduciary principle,[[61]](#footnote-61) enabled by a “technical” loophole imported from trust law, namely, “that a trustee, while forbidden to deal with himself in connection with the trust property, could deal directly with the cestui que trust if he made full disclosure and took no unfair advantage.”[[62]](#footnote-62) Writing in 1966, Marsh proclaims, “the courts have progressed from condemnation, to toleration, to encouragement of conflict of interest.”[[63]](#footnote-63)

This is a fascinating story of legal adaptation, which has been widely accepted by corporate law scholars in the U.S.[[64]](#footnote-64) The only shortcoming of the story is that it is not quite true. Norwood Beveridge first challenged Marsh’s history, arguing that conflict transactions were “never thought to be voidable without regard to fairness.”[[65]](#footnote-65) Unfortunately, this view is also somewhat overstated. Nearly a half century after Marsh’s publication, David Kershaw mediated the debate, concluding that the strict voidability rule described by Marsh was part of the story, but noting that U.S. corporate law also “created multiple paths towards fairness review.”[[66]](#footnote-66) Thus, the two standards co-existed for many years as different jurisdictions sampled from different lines of authority.

The rule of strict voidability articulated by Marsh has some support in now-dated Delaware decisions,[[67]](#footnote-67) though the Delaware courts were reluctant even then to avoid a transaction without some evidence of substantive unfairness.[[68]](#footnote-68) In 1967 the DGCL was overhauled, and one of the major amendments was the additon of Section 144, which takes aim at the voidability rule, providing a path to validity based on disclosure and approval of a conflict transaction. Section 144 provides that a conflicted transaction will not be void or voiable based soley on the existence of a conflict, if the transaction were approved by a majority of the disinterested directors or a majority of the stockholders, assuming disclosure or knowledge of all material facts relating to the conflict and assuming good faith action by directors or stockholders, as the case may be.[[69]](#footnote-69) Moreover, Section 144 provides that a conflicted transaction will not be void or voiable based soley on the existence of a conflict, if the transaction is “fair” to the corporation at the time of approval.[[70]](#footnote-70)

The jurisprudence on section 144 is confused. While the section could be read a providing a relatively clear path to validity for conflict transactions, the Delaware Supreme Court rejected this reading, reasoning instead that the statute merely removed the “cloud” of self-interest from the transaction, but did not insulate the transaction completely from judicial review for unfairness.[[71]](#footnote-71) As for the standard of review that would be applied to such transactions, the Delaware courts have waivered, stating sometimes that the transactions would be subject to business judgment review[[72]](#footnote-72) and sometimes that the transactions would remain subject to entire fairness review, with the burden of proof shifted from the defendants to the plaintiffs.[[73]](#footnote-73) The most recent authority indicates that compliance with the approval provisions of section 144 provides a “safe harbor” for conflict transactions, invoking the business judgment rule.[[74]](#footnote-74)

* 1. Disclosure and Approval

The rule that conflict transactions are voidable by beneficiaries without reference to the substantive fairness of the transaction usually is subject to an exception in cases of full disclosure and beneficiary approval in advance of the transaction.[[75]](#footnote-75) This constellation of rules applies in most common law and civil law countries, reflecting a primary concern of avoiding wrongs to beneficiaries. These rules may impede action in several ways: (1) ambiguity in the requirements for valid disclosure and approval; (2) time and expense associated with disclosure and approval; (3) the possibility of holdup and renegotiation; and (4) lingering uncertainty in the face of challenge.

Disclosure and approval may be meaningful obstacles to entrepreneurial action. Although the purpose of *ex ante* disclosure and approval is to provide some certainty in the face of conflict transactions, the requirements for effective disclosure and approval are often unclear.[[76]](#footnote-76)

Even where the requirements for disclosure and approval are fairly clear, the process of developing adequate disclosure and obtaining informed approvals can be expensive and time consuming.[[77]](#footnote-77) Under French law, for example, self-dealing transactions must be approved by the shareholders meeting on the basis of a report prepared by the board of directors of the *commissaire aux compte*.[[78]](#footnote-78)

The necessity of *ex ante* disclosure and approval may invite debates over the wisdom or structure of a particular transaction, especially in the startup context, where the relatively small number of participants may feel entitled to influence company affairs.

Finally, disclosure and approval may be inadequate, and the only cure for the conflict may be to prevent the conflict transaction from proceeding or to remove the fiduciary from participation. These dramatic solutions are rare, but the fact that they are even on the table evidences the strength of feeling about the inappropriateness of conflict transactions. As discussed below, the U.S. avoids this discussion completely by holding out substantive fairness as a sufficient condition for approval of a conflict transaction.

* 1. Administrative Approval

Discuss three examples: Section 17(a) of the Investment Company Act of 1940;[[79]](#footnote-79) German law on squeezeouts; and British takeover board.

* 1. Substantive Fairness Review

The argument that conflict regulation facilitates entrepreneurial action is straightforward: potential participants in a venture who are concerned about the possibility of opportunism by other participants may be emboldened if they believe that opportunism can be thwarted by conflict regulation. While substantive fairness review is sometimes used as an enhancement to conflict regulation – mandating not only compliance with procedural requirements for disclosure and approval, but also substantive fairness – it is often used in the U.S. as a substitute for procedural protection.[[80]](#footnote-80) Used in this way, substantive fairness review heightens the risks associated with participating in a business organization and might discourage some prospective participants from taking a chance. On the other hand, substantive fairness review facilitates actions that often benefit business organizations, and this flexibility could be attractive to prospective participants in an entrepreneurial venture.

Substantive fairness is central to the evaluation of fiduciary claims in corporations.[[81]](#footnote-81) Indeed, substantive fairness review seems to have started in this area and spread to other business organizations. Although many commentators opposed the move away from prophylactic fiduciary duties in corporate law,[[82]](#footnote-82) substantive fairness review is hard-wired into judicial standards of review. This standard is most prominently on display in merger litigation, which comprises the vast majority of corporate fiduciary claims,[[83]](#footnote-83) but it also applies in cases involving closely held corporations.[[84]](#footnote-84)

Substantive fairness review is generally viewed as quite rigorous, at least when compared with review under the business judgment rule. But the business judgment rule is not available for conflict transactions. The appropriate baseline for comparison, therefore, is not this deferential standard, but rather the more exacting traditional standard for conflict transactions, namely, the voidability of such transactions absent prior disclosure and approval.

Courts are not well equipped to evaluate the substantive fairness of the transaction.[[85]](#footnote-85) As noted by Ken Davis, “[t]he basic objective [of fairness review] is to determine whether a truly independent [fiduciary] would have produced a comparable transaction,” but the “real problem [with fairness review] from the standpoint of developing meaningful guidelines to govern decision making by corporate officers and directors is that so many conflict-of-interest scenarios pose opportunities that are unique.”[[86]](#footnote-86) One way to deal with this challenge, Davis suggests, is to insist on full disclosure and informed approval, where a small number of beneficiaries make these options logistically feasible. As noted above, however, even where the number of beneficiaries is small, these procedures are burdened with substantial shortcomings.

Prophylactic rules still have a place in fiduciary law, typically in areas outside of business organizations, including trusts, pensions, brokerages, and legal representation.[[87]](#footnote-87) In the trust setting, for example, the rules against self-dealing are strictly applied.[[88]](#footnote-88) Furthermore, these strict rules against self-dealing in the trust context are applied broadly.[[89]](#footnote-89) There is some debate about whether the strict duty is justified, even in the trust context.[[90]](#footnote-90)

Substantive fairness review is generally available in business organizations, but many people prefer *ex ante* disclosure and approval, which provides some additional comfort moving forward. In the U.S., disclosure and approval is not typically required, but it provides a “safe harbor,” shielding the action from *ex post* challenge.[[91]](#footnote-91)

1. Comparative Advantage of U.S. Fiduciary Law

The driving motivation for fiduciary law in Commonwealth countries is captured in the oft-repeated refrain that fiduciary duties are proscriptive, not prescriptive.[[92]](#footnote-92) This same idea seems to animate the disclose-and-approval rules of civil law countries. All of these jurisdictions proscribe conflict transactions,[[93]](#footnote-93) without inquiring into harm to the beneficiary or breach of any other legal norms. By contrast U.S. fiduciary law is more tolerant of conflict transactions, and we believe this follows from a strong bias in favor of entrepreneurial action.

Many authors contend that fiduciary law has a deterrence function, but Lionel Smith rightly asks, “what is being deterred?”[[94]](#footnote-94) According to Smith, fiduciary law cannot plausibly be explained as a deterrent because the level of sanction (avoidance or rescission of the conflict transaction or disgorgement of any profits) is simply too low to represent a viable deterrent for most fiduciary breaches.[[95]](#footnote-95) Moreover, the fact that “the no-conflict and no-profit rules operate independently of harm or loss to the beneficiary, bad faith of the fiduciary, the breach of other duties, or any consideration at all” means that the law is unjust because it is “willing to inflict sanctions on people who have not engaged in undesirable conduct.”[[96]](#footnote-96)

Smith suggests that rather than playing a deterrent role, fiduciary law serves as prophylactic function. According to Smith, “[d]eterrence operates by aiming to influence human decision-making; prophylaxis operates by the taking of precautions in an effort to avoid an undesirable outcome.”[[97]](#footnote-97) While some references to the prophylactic function of fiduciary law are simply references to the deterrence function, Smith suggests a different understanding of prophylaxis, which is intimately connected to the duty of unselfishness. In short, fiduciary law prohibits conflict transactions to reduce the likelihood that the fiduciary will exercise discretion for improper reasons.[[98]](#footnote-98) This is distinct from deterrence because it is not about changing the fiduciary’s motivation, but rather about implementing a precaution.[[99]](#footnote-99)

While this is a rather subtle point, it serves to emphasize the crucial difference between fiduciary law in the U.S. and fiduciary law in the Commonwealth. Fiduciary law in the U.S. cannot plausibly be viewed as a prophylactic under Smith’s reasoning because courts here do not impose a blanket prohibition on conflict transactions. Instead, courts are eager to understand whether the transaction was fair and whether the fiduciary acted in good faith.

Conclusion

In defining the boundaries of fiduciary discretion, courts tailor the general obligation of loyalty to myriad specific contexts, often consulting industry customs and social norms for guidance. Fiduciary law is often compared to tort law, in which the reliance on customs and norms has been said to chill innovation.[[100]](#footnote-100) The logic underlying this argument in the tort context is compelling: if the actions of a purported tortfeasor are measured against existing practices, novel actions increase the risk of liability, thus dampening enthusiasm for innovation. We acknowledge that tort law’s reliance on custom and norms may discourage innovation in industrial procedures, product development, or medical care, but we contend that fiduciary law’s reliance on customs and norms encourages formation of relationships that lead to entrepreneurial action.

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2. We use the language of liability self-consciously, alluding to the well-known distinction between “liability rules” and “property rules.” *See* Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 Harv. L. Rev. 713 (1996); Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972). [↑](#footnote-ref-2)
3. Consider Rock, *Dangerous Liaisons*. [↑](#footnote-ref-3)
4. Much of the jurisprudence on substantive fairness review has developed in the Delaware Court of Chancery, and it is possible that the unique legal rules are a product of this jurisdictional fact. Three features of the Court of Chancery may have influenced the development of substantive fairness review in a manner that would not have happened in other jurisdictions: (1) the Court of Chancery is staffed by judges with special expertise in the fiduciary law governing business organizations; (2) the Court of Chancery is largely a motion practice, but when trials happen, they are conducted without a jury; and (3) unlike chancery courts in England, the Court of Chancery has no jurisdiction over bankruptcy cases and it seems plausible that a prolonged exposure to “upside” cases without the counterbalancing exposure to “downside” cases would tend to produce a jurisprudence that encourages action. Of course, these are speculative musings about the institutional or psychological motivations for the substantive fairness review that are not otherwise addressed in this Article. [↑](#footnote-ref-4)
5. *See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995). [↑](#footnote-ref-5)
6. *See, e.g.*, Hamilton Partners, L.P. v. Highland Capital Management, L.P., [citation] (Del. Ch. 2014). [↑](#footnote-ref-6)
7. *See, e.g.*, Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 459 (Del. Ch. 2011) (“Entire fairness is Delaware's most onerous standard”). [↑](#footnote-ref-7)
8. *See, e.g.*, In re Crimson Exploration Inc. Stockholder Litigation, [citation] (Del. Ch. 2014). [↑](#footnote-ref-8)
9. Substantive fairness review would not have this effect if the application of the entire fairness standard always resulted in liability for fiduciaries. At one time, the Delaware courts seemed to assume that this was true. *See, e.g.,* AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (“Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation.”). The courts have subsequently observed that application of the entire fairness standard is not outcome determinative. *See, e.g.,* Nixon v. Blackwell, 626 A.2d 1366, 1376 (1993) (“Application of the entire fairness rule does not … always implicate liability of the conflicted corporate decisionmaker, nor does it necessarily render the decision void.”). [↑](#footnote-ref-9)
10. The fiduciary may moderate on price for fear of litigation, but the possibility of settling future litigation at a cost less than or not much greater than the fair value may not impose much of a constraint on self-interest seeking. [↑](#footnote-ref-10)
11. *See* Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. Rev. 413, 414 n.1 (2004) (observing that the fiduciary “sealant decayed during the twentieth century”). [↑](#footnote-ref-11)
12. The argument in this paper bears some resemblance to the argument advanced by AnnaLee Saxenian and Ronald Gilson regarding the regulation of non-competition agreements. AnnaLee Saxenian, Regional Advantage: Culture and Competition in Silicon Valley and Route 128 (1994); Ronald Gilson, 74 N.Y.U. L. Rev. 575 (1999). Saxenian and Gilson highlight the tradeoff between protection against opportunism and facilitation of innovation. [↑](#footnote-ref-12)
13. D. Gordon Smith & Travis Hunt, *Entrepreneurial Action* (working paper 2015) (defining “entrepreneurial action” as a “challenge to incumbency”). [↑](#footnote-ref-13)
14. The “lonely entrepreneur” is a common refrain. *See, e.g.,* Jeremy W. Crane, *Entrepreneurship is Synonymous with Loneliness* < http://under30ceo.com/entrepreneurship-is-synonymous-with-loneliness/> (“The business of starting one on your own, or as one would say ‘entrepreneurship,’ is lonely as hell!”). But being lonely is not the same as being alone. A serial entrepreneur describes “a different kind of loneliness” that accompanies entrepreneurs: “I would hire people, have a board of directors, investors and tons of customers – but the feeling of being alone with my ideas never went away. This is when I realized that the feeling of being ‘alone’ wasn’t just because I was a new entrepreneur, young and literally alone ... but this is a feeling that would always be with me with every venture.” Rich Swier, *Entrepreneurship is a Lonely, Dark Place Sometimes* < http://www.hubsarasota.com/blog\_view.cfm?BlogID=605>. *Cf.* Mark A. Lemley, *The Myth of the Sole Inventor*, 110 Mich. L. Rev. 709, 710 (2012) (“The canonical story of the lone genius inventor is largely a myth.”). *See also* Christoph Keese, Silicon Valley: Was Aus Dem Mächtigsten Tal Der Welt Auf Uns Zukommt 36 (2014) (contrasting the openness of business culture in Silicon Valley with the secretiveness of Germany). [↑](#footnote-ref-14)
15. In 1937, Coase famously asked, “Why is there any organization?” Ronald H. Coase, *The Nature of the* *Firm*, 4 Economica 386 (1937), reprinted in R.H. Coase, The Firm, the Market, and the Law 33, 36 (1988). He then answered his own question: “The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism.” *Id.* at 390. Fifty years later, revisited his famous work by imagining a world without firms, in which all transactions would be accomplished through contracts:

How matters would work out in detail is not easy to describe or even to imagine. One of the factors could be responsible for the sale of the product to consumers, or it could be that one would be responsible for the sale of some component, made by some factors, to other factors, with the sale of the product to the consumers being undertaken by still another, or alternatively, the consumer could contract with all the factors which provide the services to make the product. There are a vast number of possible contractual arrangements but, absent firms, none would involve the direction of factors of production. In such a system, the allocation of resources would respond directly to the structure of prices, but a great part of the available resources would be absorbed in making the arrangements for the contracts needed to bring about these transactions and in providing the information on the basis of which decisions would be made.

R.H. Coase, *Nature of the Firm: Influence*, 4 J.L. Econ. & Org. 33, 38 (1988).

Following Coase’s lead, Oliver Williamson subsequently framed this decision as a choice between markets and hierarchies. *See* Oliver Williamson, *Markets and Hierarchies: Some Elementary Considerations*, 63 Am. Econ. Rev. 316 (1973). [↑](#footnote-ref-15)
16. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399, 1431 (2002). [↑](#footnote-ref-16)
17. Peter Klein describes entrepreneurial action as “the assembly of resources in the present in anticipation of (uncertain) receipts in the future.” Peter G. Klein, *Opportunity Discovery, Entrepreneurial Action, and Economic Organization*, 2 Strategic Entrepreneurship J. 175, 183 (2008). Opportunities are products of the entrepreneur’s imagination. *See* D. Gordon Smith & Darian M. Ibrahim, *Law and Entrepreneurial Opportunities*, 98 Cornell L. Rev. 1533, 1535-36 (2013) (describing the “opportunity cycle,” beginning with resources that inspire opportunity creation, followed by opportunity exploitation, which in turn leads to the creation of new resources). [↑](#footnote-ref-17)
18. Like most entrepreneurship scholars, we distinguish entrepreneurship from invention. Many scholars attempt to measure “innovation” by studying inputs (e.g., R&D expenditures) or outputs (e.g., patents), but these studies focus on the creation of resources, not the exploitation of entrepreneurial opportunities. *See* Smith & Ibrahim, *supra* note \_\_, at \_\_. [↑](#footnote-ref-18)
19. Joseph A. Schumpeter, The Theory of Economic Development: An Inquiry Into Profits, Capital, Credit, Interest, and the Business Cycle 66 (Redvers Opie trans., Harvard Univ. Press 1961) (1934). [↑](#footnote-ref-19)
20. Startup activity has the virtue of being measurable. The problem with a broader notion of entrepreneurship is that many entrepreneurial actions are simply not susceptible to direct measurement. Thus, entrepreneurial action can occur without a startup, either because the entrepreneur does not create a formal organization or because the entrepreneur is acting within an established organization, and a startup can occur without entrepreneurial action. [↑](#footnote-ref-20)
21. The World Bank, Entrepreneurship Database 2004-2012, http://www.doingbusiness.org/data/exploretopics/entrepreneurship/. [↑](#footnote-ref-21)
22. Siri Roland Xavier et al., Global Entrepreneurship Monitor: 2012 Global Report (2013) (using survey responses to create the Total Early-stage Entrepreneurial Activity (TEA) Index). [↑](#footnote-ref-22)
23. Zoltan J. Acs et al., *What Does “Entrepreneurship” Data Really Show?*, 31 Small Bus. Econ. 265, 266 (2008). [↑](#footnote-ref-23)
24. The notion that this policy has caused important legal reforms is not new. For example, Morton Horwitz argued that judges in the U.S. during the first half of the 19th century transformed law for the benefit of entrepreneurial capitalists. *See* Morton J. Horwitz, The Transformation of American Law, 1780-1860 (1977). Horwitz does not use the term entrepreneur in any of its variations, nor does he examine fiduciary law, but his thesis is that “one of the crucial choices made during the antebellum period was to promote economic growth primarily through the legal, not the tax, system, a choice which had major consequences for the distribution of wealth and power in American society.” *Id.* at xv. [↑](#footnote-ref-24)
25. *See* Eric W. Orts, Business Persons: A Legal Theory of the Firm 1 (2013) (“Law supplies the social technology by which business enterprises are constructed and maintained.”). [↑](#footnote-ref-25)
26. In an illuminating project, five German law scholars recently tried to answer the question, “What would the ‘small’ corporation form ideally look like?” Gregor Bachmann et al., Regulating the Closed Corporation 1 (2014). The authors describe two important sources of conflict in a small corporation: the conflict between majority and minority shareholders and the conflict between shareholders and third parties, particularly creditors. *Id.* at 8-13. Potential conflicts between shareholders and directors, so prominent in large firms, were viewed as less important in small corporations, where shareholders typically manage the firms themselves or, in the case of delegated management, are able to coordinate easily as shareholders because of their small numbers. *Id.* at 8-9. Conflicts between equity owners and creditors is beyond the scope of this Article. [↑](#footnote-ref-26)
27. *See, e.g.,* Susan P. Shapiro, *Agency Theory*, 31 Ann. Rev. Soc. 263, 265-75 (2005) (surveying the use of agency theory in economics, management, political science, law, and sociology).

Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305, 308 (1976) (“We define an agency relationship as a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”). [↑](#footnote-ref-27)
28. Restatement (Third) of the Law of Agency § 1.01 (“Agency is the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise approvals so to act.”). [↑](#footnote-ref-28)
29. These are costs that are distinctive to a firm, as opposed to transactions through markets. In both firms and markets, the entrepreneur must pay for services, expend resources for supervision, and protect against self-interested behavior of the other party. The firm is distinctive from markets because the entrepreneur grants discretion over firm resources to other participants in the firm, who then become fiduciaries of the firm. *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399, 1403 (2002) (observing that “a fiduciary exercises discretion with respect to a critical resource belonging to the beneficiary, whereas most contracting parties exercise discretion only with respect to their own performance under the contract”). [↑](#footnote-ref-29)
30. D. Gordon Smith & Jordan C. Lee, *Fiduciary Discretion*, 75 Ohio St. L. Rev. 609, 610 (2014). [↑](#footnote-ref-30)
31. *See* Eric W. Orts, Business Persons: A Legal Theory of the Firm 54 (2013) (“Firms of any complexity beyond a single individual cannot exist without the law of agency.”). [↑](#footnote-ref-31)
32. Kraakman, *supra* note \_\_, at 154 (asserting that prohibiting managerial compensation and trading in the company’s shares “would simply be absurd”). [↑](#footnote-ref-32)
33. This Article focuses on conflict transactions in business organizations, but conflict transactions may be valuable in other settings. For example, Evelyn Brody observes that traditional prohibitions on conflict transactions between a fiduciary and a nonprofit organization “sweep too broadly, and void too many transactions that would benefit the charity and thus benefit the public.” Evelyn Brody, *Charity Governance: What’s Trust Law Got To Do With It?*, 80 Chi.-Kent L. Rev. 641, 656 n. 52 (2005). [↑](#footnote-ref-33)
34. *See, e.g.,* Kraakman, *supra* note \_\_, at 154 (“Directors, officers, and controlling shareholders are often the only parties with whom small companies *can* transact, ether because outsiders cannot evaluate their prospects or because these companies would be forced to reveal trade secrets or confidential plans to deal with them. More generally, a self-dealing transaction may be entered into in more favorable terms with an insider who knows the company and the risks involved than with an unrelated but distrustful party.”). [↑](#footnote-ref-34)
35. *See, e.g.,* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179, 212-13 (2012) (describing Silicon Valley as a “small world” for some venture capital investors). Conflict transactions in Silicon Valley also extend to the professionals who service startup companies. *See, e.g.,* John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 Tex. L. Rev. 405, 505 n. 525 (2002) (“From our discussions with lawyers in Silicon Valley law firms, we have anecdotal evidence that in many cases, law firms may not adequately disclose the actual and potential conflicts of interest to their clients when acquiring equity investments in the entity. Of particular concern is the failure to disclose the creeping conflicts of interest inherent in such investments in the venture capital context.”)

Some of the work of mitigating conflicts is accomplished through non-legal mechanisms, such as reputation. *See, e.g.,* Will Drover et al., *Take the Money or Run? Investors’ Ethical Reputation and Entrepreneurs’ Willingness to Parter*, 29 J. Bus. Venturing 723 (2014) (“factors previously shown to drive entrepreneurial evaluations, such as investor value-added services and investment track record…, become largely contingent upon and in some cases subjugated by an investor's ethical reputation”). [↑](#footnote-ref-35)
36. *See* Restatement (Third) of Agency, Chapter 8 (2006). [↑](#footnote-ref-36)
37. Almost all uses of these phrases in the scholarly literature come from Commonwealth lawyers. *See, e.g.,* Paul Finn, *Common Law Divergences*, 37 Melbourne U. L. Rev. 509, 524 (2013); Richard C. Nolan, *The Legal Control of Directors’ Conflicts of Interest in the United Kingdom: Non-executive Directors Following the Higgs Report*, 6 Theoretical Inquiries L. 413, 420 n. 25 (2005). For an American version of the same idea, see Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 Am. U. L. Rev. 75 (2004).

Courts in the U.S. have occasionally referred to a “conflict of duty and interest.” *See, e.g.,* Wheeler v. Abilene Nat. Bank Bldg. Co., 159 F. 391, 395 (8th Cir. 1908) (“jealous care of the fiduciary relations, from its persistent endeavor to prevent a conflict of duty and interest by removing from every person in such a relation every possible temptation to advance his own welfare in disregard of his duty to his correlate, by avoiding every transaction in which he has endeavored to do so”). U.S. courts have not used the term “conflict of duty and duty.”

Another way of describing conflicts of duty and duty is “horizontal conflicts.” *See* Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 Tex. L. Rev. 579, 591 (1992). [Examples] The usual response to such conflicts is a “fairness” standard, but this standard does not always adhere. For example, horizontal conflicts exist in the unusual case of tracking stock. *See* Jeffrey J. Haas, *Directorial Fiduciary Duties in Tracking Stock Equity Structure: The Need for a Duty of Fairness*, 94 Mich. L. Rev. 2089, 2120 n. 95 (1996) (observing “[t]he conflicts arising among competing groups of tracking stock stockholders are quintessential ‘horizontal’ conflicts”). The Delaware courts have been unwilling to impose the “entire fairness standard in cases involving tracking stock. *See, e.g.,* In re Staples, Inc. S'holders Litig., 792 A.2d 934, 937 (Del. Ch. 2001) (refusing to review the substantive fairness of a reclassification scheme designed to eliminate the company's tracking stock). [↑](#footnote-ref-37)
38. This form of misconduct is associated with corporations because minority shareholders often do not have exit options and, thus, become vulnerable to opportunistic behavior by majority shareholders. This behavior typically involves a collection of abusive tactics, including excessive retention of profits, termination of the minority shareholder’s employment, exclusion of minority shareholders from new capital issuances, failure to disclose relevant information about the firm, and repurchase of the minority shareholder’ shares at a discounted valuation. *See* Bachmann et al., *supra* note \_\_, at 39-41. [↑](#footnote-ref-38)
39. *See* Simon Johnson et al., *Tunneling*, 90 Amer. Econ. Rev. 22 (2000) (defining the term to “describe the transfer of assets and profits out of firms for the benefit of those who control them”). [↑](#footnote-ref-39)
40. *Cf.* Vicki Vann, *Causation and Breach of Fiduciary Duty*, 2006 Sing. J. Legal Stud. 86, 101 n. 67 (2006) (“[t]here is no substantive difference between a conflict of interest and duty, and a conflict of duty and duty. Both are manifestations of the overriding duty of undivided loyalty.”). [↑](#footnote-ref-40)
41. Matthew Conaglen, The Nature and Function of Fiduciary Loyalty, 121 LAW Q. REV. 452, 459-60 (2005). [↑](#footnote-ref-41)
42. Michoud v. Girod, 45 U.S. 503, 555 (1846) (when dealing with a conflict of interest, the law “acts not on the possibility, that, in some cases, the sense of that duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty”). [↑](#footnote-ref-42)
43. Michoud v. Girod, 45 U.S. 503, 555 (1846) (“The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity.”). [↑](#footnote-ref-43)
44. Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928) (“thought of self was to be renounced, however hard the abnegation”). [↑](#footnote-ref-44)
45. [↑](#footnote-ref-45)
46. *See, e.g.,*Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. Ill. L. Rev. 209, 216 (“Fiduciary duties address these problems of evaluating and controlling the manager's performance by subjecting the manager's actions to ex post judicial review. In the absence of contrary agreement, managers are subject to a duty of unselfishness.”). [↑](#footnote-ref-46)
47. Smith & Lee, *supra* note \_\_, at \_\_ (distinguishing between “appropriate” and “inappropriate” selfishness). [↑](#footnote-ref-47)
48. *See, e.g.,* Bachmann et al., *supra* note \_\_, at 55-56 (observing that, in Germany, fiduciary law requires majority shareholders to consider the interests of the corporation and the other shareholders “without completely prohibiting the consideration of personal interests”). [↑](#footnote-ref-48)
49. Li-Wen Lin & Curtis Milhaupt, *We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 Stan. L. Rev. 697, 704 (2013). [↑](#footnote-ref-49)
50. For purposes of comparison, Bachmann et al. describe three possible responses to conflict transactions: (1) prohibiting the transaction; (2) controlling without precluding the transaction (by, for example, disinterested director or shareholder approval); and (3) allowing the transaction after disclsosure. Bachmann et al., *supra* note \_\_, at 111-12. [↑](#footnote-ref-50)
51. *See* Bachmann et al., *supra* note \_\_, at 95 (noting “many jurisdictions reserve a range of decisions to the shareholders’ meeting in a mandatory way”). [↑](#footnote-ref-51)
52. *See* Bachmann et al., *supra* note \_\_, at 112 (“[s]ome corporate laws … contain a general prohibition on competition”). [↑](#footnote-ref-52)
53. Pierre-Henri Conac et al., *Constraining Dominant Shareholders’ Self-dealing: The Legal Framework in France, Germany, and Italy*, 4 ECFR 491, 499 (2007) (describing French law). [↑](#footnote-ref-53)
54. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 Bus. Law. 35, 36 (1966). [↑](#footnote-ref-54)
55. *Id.* at 37 (citing Stewart v. Lehigh Valley R. R. Co., 38 N. J. Law 505, at 523 (Ct. Err. & App. 1875)). [↑](#footnote-ref-55)
56. Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 Wah. U. L. Q. 821, 824 (2004) (defining “structural bias” as “the prejudice that members of the board of directors may have in favor of one another and of management.”). [↑](#footnote-ref-56)
57. Marsh, *supra* note \_\_, at 37 (quoting Cumberland Coal and Iron Co. v. Sherman, 30 Barb. 553, at 573 (N. Y. Sup. Ct. 1859)). [↑](#footnote-ref-57)
58. Marsh, *supra* note \_\_, at 39. [↑](#footnote-ref-58)
59. Marsh declares, “the requirement of approval by a disinterested majority of the board of directors was an abject failure.” Marsh, *supra* note \_\_, at 54. [↑](#footnote-ref-59)
60. Marsh, *supra* note \_\_, at 40. Marsh also observes that conflict transactions would be validated by shareholder ratification. *Id.* at 48 (“All of the cases seem to hold that such ratification will suffice to validate the transaction with an interested director, at least in the absence of fraud or unfairness.”). [↑](#footnote-ref-60)
61. Marsh expresses his frustration in passionate prose:

One searches in vain in the decided cases for a reasoned defense of this change in legal philosophy, or for the slightest attempt to refute the powerful arguments which had been made in support of the previous rule. Did the courts discover in the last quarter of the Nineteenth Century that greed was no longer a factor in human conduct? If so, they did not share the basis of this discovery with the public; nor did they humbly admit their error when confronted with the next wave of corporate frauds arising out of the era of the formation of the "trusts" during the 1890's and early 1900's.

Marsh, *supra* note \_\_, at 40. He later observes that some of the more recent cases involved interlocking directorates, rather than contracts with interested directors, but he does not draw much comfort from distinguishing these cases. *Id.* at 44. [↑](#footnote-ref-61)
62. Marsh, *supra* note \_\_, at 40. [↑](#footnote-ref-62)
63. Marsh, *supra* note \_\_, at 57. [↑](#footnote-ref-63)
64. *See* David Kershaw, *The Path of Corporate Fiduciary Law*, 8 N.Y.U. J. L. & Bus. 395, 439 (2012) (describing Marsh’s account as “widely accepted in the U.S. corporate law debate”). [↑](#footnote-ref-64)
65. *See* Norwood P. Beveridge, Jr., *The Corporate Director’s Fiduciary Duty of Loyalty: Understanding the Self-interested Director Transaction*, 41 DePaul L. Rev. 655, 659-60 (1992) (calling Marsh’s conclusion “completely erroneous”) (hereinafter, “Beveridge, *Understanding*”). In a later article, Beveridge had expressed frustration that his attack on Marsh’s thesis has not been embraced by other corporate law scholars: “Marsh's contention that contracts between a director and the corporation were generally prohibited at common law came under attack in 1992 as completely erroneous. This suggestion has been met with a good deal of interest, but not with a corresponding degree of acceptance.” Norwood P. Beveridge, Jr., *Interested Director Contracts at Common Law: Validation Under the Doctrine of Constructive Fraud*, 33 Loyola L.A. L. Rev. 97, 98-99 (1999) (hereinafter, “Beveridge, *Validation*”). [↑](#footnote-ref-65)
66. David Kershaw, *The Path of Corporate Fiduciary Law*, 8 N.Y.U. J. L. & Bus. 395, 441-42 (2012). [↑](#footnote-ref-66)
67. *See, e.g.*, Kerbs v. California Eastern Airways, Inc., 90 A.2d 652 (Del. 1952) (holding that a profit-sharing plan was voidable because it was approved by interested directors). The rationale for the voidability rule was a basic distrust of conflicted decision makers. *See* Potter v. Sanitary Co. of Am., 194 A. 87, 91 (Del. Ch. 1937) (describing an unapproved conflict transaction as “constructively fraudulent”). For a discussion of these and other Delaware decisions under section 144, *see* Edward P. Welch et al., Folk on the Delaware General Corporation Law §144.02, p. 4-368 (6th ed. 2015). [↑](#footnote-ref-67)
68. *See, e.g.*, Blish v. Thompson Automatic Arms Corp., 64 A.2d 581, 602 (Del. 1948); Keenan v. Eshleman, 2 A.2d 904, 908 (Del. 1938). [↑](#footnote-ref-68)
69. 8 Del. C. § 144(a)(1) and (2). [↑](#footnote-ref-69)
70. 8 Del. C. § 144(a)(3). [↑](#footnote-ref-70)
71. Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976). [↑](#footnote-ref-71)
72. *See, e.g.,* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n. 34 (Del. 1993); Marciano v. Nakash, 535 A.2d 400, 405 n. 3 (Del. 1987). [↑](#footnote-ref-72)
73. *See, e.g.,* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1169 (Del. 1995); Cooke v. Oolie, [citation] (Del. Ch. June 23, 1997). [↑](#footnote-ref-73)
74. Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 115 (Del. 2006). [↑](#footnote-ref-74)
75. We focus on fiduciary law, but all common law jurisdictions also regulate conflicts to some extent with statutes. In Australia, the Corporations Act 2001 has provisions that operate “in addition to, and not in derogation of … any general rule about conflicts of interest.” See Corporations Act 2001 (Cth) § 193. [↑](#footnote-ref-75)
76. *See, e.g.,* Langford & Ramsay, *supra*  note \_\_, at 108 (observing that conflicted directors face a “dilemma” because “courts have not always clearly articulated the relevant factors or requirements” for avoiding a breach of duty). Lanford and Ramsay cite this remarkable passage from Owen J in Fitzsimmons v R:

Each case will depend on its own facts. A director who is confronted with a possible conflict must assess his or her position. The minimum requirement will be disclosure of the interest. This is simply part of, or an extension of, the statutory obligation that a director who is in any way ‘interested’ in a contract or proposed contract with the company must declare the nature of the interest at a meeting of the directors…. What action, above and beyond mere disclosure, the director must take will vary from case to case depending on the subject matter, the state of knowledge of the adverse information, the degree to which the director has been involved in the transaction, whether the director has been promoting the cause, the gravity of the possible outcome, the exigencies and commercial reality of the situation and so on. It may be enough for the director simply to refrain from voting or even to absent himself or herself from the meeting during discussion of the impugned business. The circumstances may require the director to take some positive action to identify clearly the perceived conflict and to suggest a course of action to limit the possible damage…. But this does not mean that the director is obliged to resign his office. That may, in particular circumstances, be the only course open but it would not necessarily follow.

23 ACSR 355, 358 (1997). [↑](#footnote-ref-76)
77. Zohar Goshen, *Conflicts of Interest in Publicly-Traded and Closely-Held Corporations: A Comparative and Economic Analysis*, 6 Theoretical Inquiries L. 277, 297-99 (2005) (“Negotiations within a small group of people, in a setup where each person is free to accept or reject the terms of the transaction, entail very low costs. On the other hand, once the corporation is operating and running, the existing shareholders face very high negotiation costs when trying to resolve a problem of conflict of interest. At this stage, the shareholders are locked-in. The small number of people in the group creates a very high risk of hold-out if a property rule is adopted. Imagine a requirement of approval by a majority of the minority for conflicted transactions in a corporation with three shareholders. In every transaction with one of the shareholders, each of the other two will have veto power over the execution of the transaction. Moreover, no market is there to ameliorate this problem.”) [↑](#footnote-ref-77)
78. Art. L. 223-19 C.com. The conflicted shareholder must abstain from voting in this procedure. [↑](#footnote-ref-78)
79. Marsh, *supra* note \_\_, at 51-53. [↑](#footnote-ref-79)
80. Niels B. Schaumann, *The Lender as Unconventional Fiduciary*, 23 Seton Hall L. Rev. 21, 31 (1992) (asserting “[f]iduciary law serves two primary purposes: it deters the abuse of fiduciary power and provides a means for reviewing the terms of contracts between the fiduciary and the beneficiary for substantive fairness”). [↑](#footnote-ref-80)
81. *See, e.g.,* Jill E. Fisch et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 Tex. L. Rev. 557, (2015) (arguing that “the core concern of state fiduciary duty litigation with regard to mergers is the substantive fairness of the transaction”). [↑](#footnote-ref-81)
82. *See, e.g.,* Victor Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 Mich. L. Rev. 259, 299-300 (1966) (arguing that relaxation of standards governing fiduciaries will hurt shareholders). [↑](#footnote-ref-82)
83. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (reasoning that the “concept of fairness has two basic aspects: fair dealing and fair price,” the latter of which “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock”). Courts have recognized substantive fairness in this context as a feature of state fiduciary law. *See* Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 478 (1977) (holding “once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the” federal securities laws). [↑](#footnote-ref-83)
84. Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. Pa. L. Rev. 1675, 1675-76 (1990) (“It is my thesis that courts, aided in part by legislatures,increasingly have moved away from applying broad prophylactic fiduciary principles to prevent or resolve intra-corporate conflicts. In the context of close corporations,courts have quietly abandoned those principles and replaced them with remedial approaches which focus on the putative fiduciary's wrongful conduct. The result is a subtle but significant change in the law's normative aspirations from those on which classic fiduciary principles are based.”). [↑](#footnote-ref-84)
85. *See* Davis, *supra* note \_\_, at 63 (noting “in a significant number of cases it is simply not realistic to ask the courts to predict, in the guise of finding ‘facts,’ how a theoretically independent board would have approached a problem or what terms it would have negotiated”). *See also,* Jeffrey N. Gordon, *“Just Say Never?” Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 Cardozo L. Rev. 511, 516 (1997) (noting “[f]iduciary policing is hard, because it requires decisions of substantive fairness”). *But see* Fisch et al., *supra* note \_\_, at 602 (asserting “Delaware law and Delaware courts … are well-suited to pass on the substantive fairness of merger transactions”). [↑](#footnote-ref-85)
86. Davis, *supra* note \_\_, at 63-64. [↑](#footnote-ref-86)
87. This is an ERISA case. See Brown v. Blue Cross & Blue Shield of Ala., Inc., 898 F.2d 1556, 1565 (11th Cir. 1990) (disclaiming that the rule is intended to deprive the fiduciary of any unjust enrichment or to compensate the beneficiary, rather, its sole purpose and effect is to deter the formation of arrangements where a conflict may arise). [↑](#footnote-ref-87)
88. Trustees have a “duty to **administer the trust solely in the interest of the beneficiaries,”** and to “deal fairly” with the beneficiaries. Restatement (Third) of Trusts § 78. This duty is said to be “strict,” meaning that the Co-Trustees are prohibited from engaging in transactions that involve a conflict of interest, unless**, among other things, they receive court authorization, the terms of the trust expressly authorize such transactions, or the beneficiaries approval to such transactions.** Restatement (Third) of Trusts § 78 cmts. c(1), c(2), and c(3). *See also,* Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 Cornell L. Rev. 621, 680 (2004) (“trust fiduciary law, especially the duty of loyalty, is stricter and more prophylactic than the fiduciary law of other organizational forms”). [↑](#footnote-ref-88)
89. See Scott on Trusts, 4th ed. § 170.6 (Little, Brown and Co., 1987). [↑](#footnote-ref-89)
90. *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 Yale L.J. 929, 931 (2005) (advancing the view that “the sole interest rule is unsound”). [↑](#footnote-ref-90)
91. Broz v. Cellular Information Systems, Inc., 673 A.2d 148, 157 (Del. 1996). [↑](#footnote-ref-91)
92. In Australia, this idea stems from the well-known case of Breen v. Williams, 186 CLR 71 (Aus. High Court 1996), which held “equity imposes on the fiduciary proscriptive obligations – not to obtain any unauthorized benefit from the relationship and not to be in a position of conflict…. But the law of this country does not otherwise impose positive legal duties on the fiduciary to act in the interests of the person to whom the duty is owed.” *Id.* at 113. The Court contrasted this approach with the Canadian approach, where the cases “reveal a tendency to view fiduciary obligations as both proscriptive and prescriptive.” *Id.* *Breen* involved a doctor-patient relationship, but the principle has been followed in cases involving business organizations. *See, e.g.,* Pilmer v. Duke Group Ltd., 207 CLR 165 (2001) (duties in a partnership are proscriptive, not prescriptive). [↑](#footnote-ref-92)
93. The scope of regulation is subject to manipulation. In Australia the duty to avoid unauthorized conflicts was at one time applied to any possible conflict, but it is now applied to a “real sensible possibility of conflict.” Rosemary Teele Langford & Ian M. Ramsay, *Conflicted Directors: What is Required to Avoid a Breach of Duty?*, 8 J. Equity 108, 109 (2014) (citing Boardman v Phipps 2 AC 46, 124 (HL) (1967) per Lord Upjohn). [↑](#footnote-ref-93)
94. Lionel Smith, *Deterrence, Prophylaxis and Punishment in Fiduciary Obligations*, 7 J. Equity 87, \_\_ (2013). [↑](#footnote-ref-94)
95. Smith, *supra* note \_\_, at \_\_ (“Indeed, it would have the contrary effect: unless the chances of detection and litigation were 100%, there would always be more overall profit in defrauding as often as possible than in not defrauding.”). [↑](#footnote-ref-95)
96. Smith, *supra* note \_\_, at \_\_. [↑](#footnote-ref-96)
97. Smith, *supra* note \_\_, at \_\_. [↑](#footnote-ref-97)
98. Smith, *supra* note \_\_, at \_\_. [↑](#footnote-ref-98)
99. Smith, *supra* note \_\_, at \_\_. [↑](#footnote-ref-99)
100. Gideon Parchomovsky & Alex Stein, *Torts and Innovation*, 107 Mich. L. Rev. 285 (2008) (arguing that “courts' reliance on customs and conventional technologies as the benchmark for assigning tort liability chills innovation and distorts its path”). [↑](#footnote-ref-100)