



OTHER PEOPLE'S MONEY

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INTRODUCTION

I was in one board meeting, and I said, “I started this [company] to do positive things with the world and do good in the Amazon, not necessarily to get a big payout.” . . . And one of [the angel investors] looked me in the eye and said, “Well, the problem is, then you went out and took \$9 million of other people’s money.”¹

Legal principles that are almost right are often more mischievous than those that are completely wrong. What is transparently wrong is interpreted narrowly (or ignored altogether) and is likely to be repealed. An almost-right principle invites sloppy thinking, vague generalities, and a general distortion of the otherwise sound ideas that lie close by. An example of an almost-right principle that has distorted much of the thinking about corporate law in recent decades is the oft-repeated maxim that directors of a corporation owe a fiduciary duty to the shareholders.

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1. Gwendolyn Bounds, *The Perils of Being First*, WALL ST. J., Mar. 19, 2007, at R1.

This principle (embraced by the Supreme Court in the nineteenth century² and as recently as last May by the Delaware Supreme Court³) is not on its face silly. A board of directors, as Adam Smith observed long ago, is charged with taking care of other people's money,⁴ and it is usual in such cases for the law to impose special and unremitting duties. After all, directors lack the "anxious vigilance" that we use when looking after our own money.⁵ Hence, directors should have a general legal duty to care for this money as a reasonable person would care for it if acting on her own account.⁶

The money in question usually is thought to belong to the shareholders. They contribute capital in the first place, they typically elect the board, and their blessing is required for major transactions. They stand to gain a dollar if the directors make the right decision and lose a dollar if they make the wrong one. In short, "the corporate contract makes managers the agents of the equity investors."⁷ As the residual claimants, and unlike most creditors,⁸ "[t]hey receive few explicit promises. Instead they get the right to vote and the protection of fiduciary principles."⁹

But this is not the whole story. The common stockholder is merely one

2. *See* *Koehler v. Black River Falls Iron Co.*, 67 U.S. (2 Black) 715, 720-21 (1862) ("[Directors] hold a place of trust, and by accepting the trust are obliged to execute it with fidelity, not for their own benefit, but for the common benefit of the stockholders of the corporation.").

3. *See* *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders.").

4. ADAM SMITH, *THE WEALTH OF NATIONS* 700 (Edwin Cannan ed., Modern Library 1937) (1776). We are not the first to borrow this from Smith. It was the title of a series of essays by Louis Brandeis published in 1914. *See* LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT* (1914) (criticizing bankers who sat on boards and controlled firms to do the bidding of the bank, despite the fact that the bankers were investing other people's money). It is also the title of a 2004 screed against investment bankers and President George W. Bush by a former managing director of Goldman Sachs. *See* NOMI PRINS, *OTHER PEOPLE'S MONEY: THE CORPORATE MUGGING OF AMERICA* (2004). *Other People's Money* was also the title of a 1991 film by Norman Jewison starring Danny DeVito and Gregory Peck (based on a play by Jerry Sterne). *OTHER PEOPLE'S MONEY* (Warner Bros. Pictures 1991). OPM was the name of a corporation whose owners possessed a more acute awareness of acronyms and irony than its customers. It perpetrated one of the major frauds of the 1980s.

5. SMITH, *supra* note 4, at 700.

6. The obvious analogy, and one we make below, is to the law of trusts. *See infra* notes 85-87 and accompanying text.

7. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 91 (1991). Easterbrook and Fischel link the fiduciary obligations of the directors to the residual claimants, not to equity holders per se. As we explore below, this is not quite right either.

8. So-called "contract" creditors, or ones who voluntarily enter into loan, bond or other debt agreements with the firm usually set out many obligations in the investment contract. Involuntary creditors, such as tort victims, do not, of course, enjoy such protections.

9. EASTERBROOK & FISCHEL, *supra* note 7, at 91.

flavor of investor.¹⁰ Others, such as lenders, bondholders, and preferred stockholders, also stand to gain or lose with right or wrong decisions.¹¹ Moreover, with the right package of derivatives, a debtholder can enjoy the same cashflow rights as an equityholder and vice versa.¹² Shareholders ordinarily control the board, but any number of devices (from loan covenants to voting trusts) can give this power to other investors, including creditors and preferred stockholders.¹³ As financial innovation has accelerated over the past two decades, the terms “shareholder” and “debtholder” or “creditor” have become less meaningful.¹⁴ Identifying only shareholders as investors, as opposed to all providers of capital, is misleading. The problems likely to arise

10. We are, of course, not the first to point out that shareholders are not always or the only residual claimants and that larger constituencies need to be taken into account. Blair and Stout, among others, have done the important work here. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 276-87, 314 n.178 (1999); *see also* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005) (arguing for management discretion regarding corporate philanthropy in part because of multiple claimants); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1192-95 (2002) (discussing why shareholders cannot be sole residual claimants).

11. In this Article, we focus narrowly on investors, not on the many others (from workers to surrounding communities) whom the corporation affects. Our focus here—on the way that thinking of fiduciary duties running to, or only to, shareholders is an almost-right but pernicious idea—stands apart from whether the law should oblige the board to take other, non-financial stakeholders into account. The corporate social responsibility debate is about taking power away from *investors* and giving it to stakeholders, whereas our project is about identifying exactly who the investors are and how to make sense of the relationships among them.

12. Consider two simple examples. A stockholder (who is in a long position) can buy a put option to create a floor for any losses and sell a call that would create a ceiling on any gains. Debtholders can buy call options or get conversion rights that give them the potential to capture upside beyond the plain terms of their debt contract. There are an infinite number of permutations that allow both equityholders and debtholders to create such synthetic positions. This process has been going on for a long time. *See* Merton H. Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. FIN. & QUANTITATIVE ANALYSIS 459, 460-63 (1986). For a discussion in the context of tax law, *see* Alvin C. Warren, Jr., Commentary, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 461 (1993) (“Continuous disaggregation, recombination, and risk reallocation have produced a changing array of new financial contracts that pose a serious challenge for the income tax.”).

13. *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006).

14. With credit derivatives, debt, which was once held in large blocks and subject to large, heavily negotiated, and covenant-laden contracts, is now sold off into tiny slices to thousands of investors and is subject to many fewer contractual protections. In other words, it looks much more like equity. Equity, which is increasingly finding its way into large private equity funds, takes on some debt-like characteristics, since it is not tradable (at least for many years) and is often held in large blocks and in convertible forms. We could go on and on, and in fact, one of us does in other work. *See* M. Todd Henderson, *Monitoring in a Financially Sophisticated World* (2008) (working paper, on file with author). For now it is sufficient to state that the lines are increasingly blurry.

are already evident,¹⁵ and the current surge in financial innovation will likely exacerbate them.¹⁶

The notion that fiduciary duties are owed to shareholders has not yet generated seriously wrong-headed outcomes. (Among other things, the Delaware chancellors are generally too smart to let this happen.)¹⁷ Nevertheless, the reasoning needed to navigate around the sacred cow that the duty of the directors is owed solely to the shareholders has become increasingly awkward. People who should know better paint themselves into embarrassing corners trying to reaffirm the principle.¹⁸ The problem is not as simple as whether investors have offensive fiduciary duty claims (i.e. whether fiduciary duties oblige directors to take particular actions). Creditors are more typically arguing for the disablement of duties owed shareholders.¹⁹ They have

15. Modern financial engineering enables investors to parse capital structures—cash-flow rights, voting, and so on—in ways that make any attempt to pigeonhole investments as one type or another nearly meaningless. One prominent example of the confusion created by crude labels is the conduct surrounding the proposed merger of Mylan and King, two pharmaceutical companies. The market believed that this was a bad deal for Mylan (the buyer) but a good one for King (the target). An investor in King wanted the deal to go through, so it engaged in a series of transactions whereby it could in effect buy votes in Mylan, which it would then vote in favor of the deal, without exposing itself to the economic risk of the transaction—what is known as “vote buying.” See John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1750 (2007) (describing vote buying in the Mylan-King deal as “abuse” and doubting the SEC’s authority to regulate the practice, absent a new congressional statute). For analysis of the problems that can arise through this fragmentation of ownership interests, see Henry T.C. Hu & Bernard S. Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications* (Univ. of Tex. Law, Law and Econ. Research Paper No. 120, 2008), available at <http://ssrn.com/abstract=1084075>.

16. See, e.g., Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007) (describing the new financial products that allow holders of credit to share risk).

17. Many Delaware cases contain dicta suggesting that the interests of “the corporation” can be interpreted to include other stakeholders’ interests. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (authorizing takeover measures designed to protect unenumerated corporate policies). Legal academics and, more importantly, business people, fall prey to the “shareholders only” mistake with much more frequency.

18. See, e.g., Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321 (2007). Hu and Westbrook argue that directors should owe their duties exclusively to equityholders until the corporation is in bankruptcy. Once having done this, however, they must explain how the directors could ever file a bankruptcy petition (something they think directors should be able to do). They equivocate about how the shareholders might themselves benefit from a bankruptcy petition (something that is rarely true), confess that the problem is hard, and then admit that “[m]uch theoretical and empirical analysis [including many research grants] will be essential in the years ahead.” *Id.* at 1402.

19. There are “offensive” and “defensive” assertions of owed fiduciary duties by both shareholders and creditors. Offensive cases are those in which shareholders or creditors claim that fiduciary duties are owed to them. Shareholders made this claim in *Orban v.*

sufficient influence over the directors such that the directors are willing to take actions in the creditors' favor, provided only that fiduciary duties owed shareholders do not constrain them. Directors, who must make difficult decisions and who are often forgotten in these cases, must also have clear rules about how they should act—the cases, even if coming to the right result in most instances, leave this question largely unanswered.

If we are right that fiduciary duties are becoming more harmful than helpful, the question becomes what principle ought to replace the idea that fiduciary duties are owed shareholders. The most obvious one follows naturally from the idea that *ex ante* investors presumptively are interested in maximizing the value of the firm. Following the lead of Circuit Judge Easterbrook in *In re Central Ice Cream Co.*,²⁰ we might instead adopt the following principle: The directors must adopt the course that, in their judgment, maximizes the value of the firm as a whole. This principle of value maximization could also be coupled with a strong business judgment rule. Courts lack information and expertise that would allow them to effectively and efficiently police director decisions and cannot easily determine under any set of facts whether a particular decision was, when made, designed to maximize firm value. Hence, the directors must enjoy a large measure of discretion, and claims by one class of investor against another alleging breach of a fiduciary duty would fail so long as the directors acted reasonably to enhance firm value.²¹

Under this view, there is little we can say about the duties of directors other than that directors should maximize the value of the firm. They rarely, if ever, will be held liable for a decision that, notwithstanding its effect on one type of investor, maximizes firm value²² (unless their action violates some specific

Field, No. 12820, 1997 Del. Ch. LEXIS 48 (Del. Ch. Apr. 1, 1997), *see infra* notes 92-99 and accompanying text, and *Blackmore Partners v. Link Energy*, No. Civ. A 454-N, 2005 WL 2709639 (Del. Ch. Oct. 14, 2005), *see infra* note 34 and accompanying text. Creditors made similar claims in *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007). *See infra* note 82 and accompanying text. Defensive cases are those in which shareholders or creditors claim that fiduciary duties are not owed to the other. An example of a shareholder defensive claim is *In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987). *See infra* notes 74-77 and accompanying text. Creditors made a defensive claim in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). *See infra* notes 78-84 and accompanying text.

20. *In re Central Ice Cream*, 836 F.2d 1068; *see infra* notes 74-77 and accompanying text.

21. For an insightful analysis of the way in which traditional focus upon the agency costs between shareholders and managers falls short, see Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 71-74 (2006) (discussing agency conflicts in venture capital contracts among investors as well as between managers and shareholders).

22. *See Blair & Stout*, *supra* note 10, at 298-309, 321-22 (“In particular . . . shareholders should be allowed to sue directors *only* when this serves the interest of the corporation as a whole, rather than serving shareholders’ interests at the expense of other stakeholders.”).

covenant or by-law), and directors invite trouble (but do not necessarily expose themselves to liability) if they make a decision that reduces the value of the corporation. This view follows from the traditional law and economics approach to corporate law.²³

In this Article, however, we suggest that this approach too may be wanting. Sophisticated investors negotiating for combinations of cash-flow and control rights might well choose models that depart from the simple one that requires directors to always maximize firm value. In some instances the efficient ex ante bargain may include terms that look inefficient ex post.²⁴ For example, creditors may need to be able to have the ability to engage in self-serving behavior that compromises the value of the business as a whole in order to ensure that the shareholders have the right set of incentives in the previous period. In other words, the real option for one investor to take disproportionate value from the firm under certain circumstances gives other investors and managers incentives to avoid these circumstances. Imposing a value-maximizing duty, even with a strong business judgment rule, may be contrary to what the investors want in their ex ante bargain.

At first cut, we should respect the choices investors and directors make, even if they seem to create situations where the board acts in ways that appear to destroy firm value.²⁵ Corporate finance and corporate governance are not one-size-fits-all, and firm capital structures are heterogeneous, complex, negotiated, and, most importantly, priced by the market. From this perspective, courts should tread lightly, even when faced with self-serving behavior, lest they upset what they do not understand.²⁶ Our understanding of capital

23. See, e.g., Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 29-30 (1990) (arguing that fiduciary duties are simply part of the private ordering of control rights). For a discussion of other work that focuses on the idea of maximizing firm value, see *infra* notes 88-89.

24. One possibility is the incentive-to-do-well argument we float below. See *infra* notes 102-06 and accompanying text.

25. This is especially true when there is little reason to doubt that the contracts were entered into voluntarily, by parties with knowledge about the terms of the contract and with more or less equal bargaining power.

26. An important distinction here must be made between director conduct that is purely self-serving and conduct that is doing the bidding of those who installed them and that may incidentally benefit the director personally. Imagine two cases: in the first, a director elected by shareholders votes to approve a transaction in which the firm buys a piece of land from him at a significant premium to its market value; in the second, a director appointed pursuant to a contract with a senior creditor, votes to approve a transaction that benefits the creditor (and himself) at the expense of the common shareholders. As we discuss below, it is possible, perhaps even likely, that the second case is a part of the efficient ex ante bargain among investors, and courts should be cautious before disrupting these transactions. The first is obviously a classic self-dealing transaction that any court would disrupt absent ratification by a disinterested board or shareholder vote. Of course, there is a danger that courts will not be able to readily distinguish these two cases (and that the directors in the first case will dress it up to look like the second), but these concerns are overblown. The world we imagine—where there are no fiduciary duties—is one that would

structures is simply too primitive for us to do much more than enforce the contracts that are written as best we can. The default rules we devise—and fiduciary obligations are simply one of these²⁷—should be in service of these contracts.²⁸ Imposing duties on directors that are too rigid or too mechanical may limit the ability of investors to create capital structures that are beyond the ken of those writing the rules.²⁹

This is especially true since investors cannot easily opt out of a fiduciary duty once it is put in place.³⁰ Hence, it may make sense to eliminate the concept of fiduciary duty from corporate law altogether.³¹ Rather than any

still permit courts to police obvious self dealing, while preserving the ability of investors to bargain for efficient control rights. Red flags will be raised not only in cases where directors profit personally in ways that are unique to them, but also in cases in which directors vote in ways that are different from the interests of those who installed them on the board.

27. See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993) (arguing that fiduciary duties are necessary gap filling by courts for incomplete contracts written by shareholders and firms).

28. The principal virtue of using fiduciary duties is contracting efficiency. Inevitable gaps in control right contracts might permit powerful individuals to engage in unanticipated self-serving behavior, thus increasing the firm's cost of capital or, at a minimum, the transaction costs of doing deals as lawyers try to negotiate ever more comprehensive agreements. One solution is to use the duty of good faith and fair dealing as is commonly done with ordinary contracts.

29. There is a robust literature on the so-called “common agency” problem—that is, where multiple principals (investors) are designing an incentive structure for a single agent (managers). See, e.g., B. Douglas Bernheim & Michael D. Whinston, *Common Agency*, 54 ECONOMETRICA 923 (1986); Joel S. Demski & David Sappington, *Optimal Incentive Contracts with Multiple Agents*, 33 J. ECON. THEORY 152 (1984); Bengt Holmström & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991). The models in this work are largely unhelpful here, since they deal with coordination issues, private information, and incentive schemes designed in environments that look very little like the ex ante corporate bargain. See, e.g., Fahad Khalil et al., *Monitoring a Common Agent: Implications for Financial Contracting*, 135 J. ECON. THEORY 35 (2007) (modeling the monitoring incentives of principals in the face of privately informed agents and financial contracts designed in isolation of each other).

30. See Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 887 (“[F]iduciary obligation sometimes operates precisely in opposition to intention as manifest in express agreements.”); see also *id.* at 923 (“A provision in a trust instrument cannot relieve a trustee of liability for any profit derived from a breach of trust . . .”). The Uniformed Trust Code limits the ability of the parties to modify fiduciary duties. Section 105(b)(2) and (3) provide that the parties may not waive “the duty of the trustee to act in good faith and in accordance with the purposes of the trust” nor “the requirement that a trust and its terms be for the benefit of the beneficiaries.” UNIF. TRUST CODE § 105 (2005).

31. Firms are, with shareholder approval, generally authorized to indemnify directors for some breaches of fiduciary duties. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2008). Indemnification is limited to cases not involving bad faith and is ineffective at preventing suits designed to extract payment short of the final disposition of the case. Furthermore, the existence of a financial cushion for directors does not necessarily give the right incentives to those directors who want to do what the law requires instead of what won't cost them personally. Indemnification also does not lessen the bite of fiduciary duties in other related areas, like duties to disclose. See *infra* Part IV.

generalized duty to shareholders or to the firm or to sometimes shareholders and sometimes creditors, directors should merely be obliged to honor the terms of the firm's investment contracts, even when they lead to decisions that are not value-maximizing ex post for the investors as a group. Directors would merely have the duty to attend to the affairs of the corporation and act in good faith, a duty owed to investors and strangers alike. In this world, shareholders, like creditors, must protect themselves through their powers under the corporate charter and the by-laws.

This Article proceeds in four parts. Part I shows how the maxim that fiduciary duties are owed to shareholders cannot be reconciled even with current doctrine. Part II goes on to show how the effort to sort out with greater particularity what duties are owed to whom is doomed to fail. Here we use the recent mess in Delaware over fiduciary duties in the "zone of insolvency" as our principal exhibit. This Part goes on to examine the paradigm that sits most comfortably with current thinking about corporate law in the courts and in the academy—the idea of fiduciary duties being owed to the firm as a whole, coupled with a strong business judgment rule. Part III shows how this principle itself may be wanting and sets out an alternative paradigm, one in which no fiduciary duties exist at all, and directors face liability for their decisions (other than for neglect or surreptitious self-dealing)³² only if they violate a contractual obligation owed to a shareholder, creditor, or other investor.

Part IV briefly shows how separating corporate law from conceptions of duty brings needed clarity to the often-litigated issue of disclosure duties.³³ The problem, we suggest, is largely contractual, and in setting the default rules, the focus should be on the ability of parties to opt out—or opt in.

I. FIDUCIARY DUTIES TO SHAREHOLDERS

Directors routinely make decisions that unambiguously favor creditors and other investors at the expense of the holders of common stock. The most obvious example is the filing of a bankruptcy petition, the immediate effect of which is to destroy the option value of the equity of the business for the benefit of creditors. No one claims that doing this violates directors' duties, and courts generally do not intervene in decisions about whether to file a bankruptcy petition.³⁴ This is only the most obvious example of what boards can do at the

32. For the importance of maintaining a prohibition on self dealing by insiders and directors, see Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209.

33. As we show, modern securities law and doctrines such as insider trading are premised entirely on state-law fiduciary duties. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 662 (1997) (noting that "§ 10(b) liability 'is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction'" (citing *Chiarella v. United States*, 445 U.S. 222, 230 (1980))).

34. In *Odyssey Partners, L.P., v. Fleming Companies, Inc.*, 735 A.2d 386 (Del. Ch. 1999), a shareholder sued for breach of fiduciary duty on the ground that the firm did not file

expense of shareholders and to the benefit of other investors. When the examples are tallied together, the conventional account of fiduciary duties being owed to shareholders cannot be reconciled with existing law, even when coupled with an extremely deferential business judgment rule.

A. Board Discretion

A board of directors can combine two businesses in a manner that denies shareholders of one the ability to vote on the transaction.³⁵ For example, in Delaware, shareholders of both the “buyer” and “seller” are entitled to vote on all statutory mergers.³⁶ The board of a buyer, however, can take the vote away from its own shareholders by structuring the merger as a triangular merger: the board creates a subsidiary firm of the buyer, of which the buyer firm is the only shareholder, and then executes a merger between the seller firm and the subsidiary.³⁷ The subsidiary holds a vote on the merger, and the buyer firm votes its one share in the subsidiary (as per a majority vote of the buyer’s board) in favor of the merger. There is no judicial check, say through a “business purpose” test, on the rationale for structuring a merger in the form of a triangle, nor any need to show that the structure maximizes firm value.³⁸

The board may do the same thing with shareholders’ appraisal rights.³⁹ The right to receive a judicial appraisal of shares in a merger, like the right to vote, is enshrined in state corporate law statutes. The origin of the appraisal remedy can be traced back to the change in the voting rule for certain fundamental transactions from unanimity to majority rule—the appraisal right was the quid for the quo of allowing transactions to proceed against the will of

a Chapter 11 petition, and instead allowed another shareholder, who was the firm’s largest creditor, to foreclose on firm assets. The court rejected this claim, noting that the board balanced the effects of various courses of action on shareholders and “creditors and other corporate constituencies” and the decision was to be respected so long as it was not “disloyal to [the firm], taken as a whole.” *Id.* at 420; *see also* Blackmore Partners, LLP, v. Link Energy, Inc., No. Civ.A. 454-N, 2005 WL 2709639 (Del. Ch. Oct. 14, 2005) (holding that the board could take actions that benefited creditors at the expense of shareholders—that is, getting nothing for shareholders in an asset sale after rejecting a plan that would have returned something to equity holders).

35. *See* DEL. CODE ANN. tit. 8, § 251(c) (West 2008) (providing that a merger is valid only if approved by a majority of shareholders of both buyer and seller).

36. *See id.* (providing that a vote must be taken by “each constituent corporation” to the agreement).

37. Various permutations of this basic idea allow selling-firm shareholders to accomplish a similar result.

38. *See, e.g.,* Rauch v. RCA Corp., 861 F.2d 29 (2d Cir. 1988) (rejecting claims that a triangular merger was an improper redemption of stock under Delaware law); Hariton v. ARCO Elecs., Inc., 188 A.2d 123, 125 (Del. 1963) (rejecting business purpose test and de facto merger doctrine).

39. *See* DEL. CODE ANN. tit. 8, § 262 (West 2008) (giving shareholders who vote no on certain business combination transactions the right to a judicial appraisal process of the value of their shares at the time of the transaction).

certain shareholders.⁴⁰ It was viewed as an essential stick in a shareholder's bundle of rights. And yet, boards can take it away, and can do so for no reason at all. Boards may structure transactions for the sole purpose of limiting the ability of shareholders to perfect appraisal rights.⁴¹

The board may also decide, on its own or at the behest of a majority shareholder, to buy out the shares of the minority shareholders even if this is not in the best interests of minority shareholders.⁴² It may do so even without stating a business purpose and without any consideration as to the impact on minority shareholders. As the Delaware Supreme Court has held on many occasions, "[i]t is . . . settled under Delaware law that minority stock interests may be eliminated by merger."⁴³ It also may do so without sharing the control premium: controlling shareholders, who also owe fiduciary duties to minority shareholders, may sell their control shares without sharing the control premium with the minority.⁴⁴

In day-to-day activities, long-term project choices, and fundamental transactions, boards may prefer long-term shareholders over short-term shareholders or vice versa. There is no ready check on this ability to choose which type of shareholder to prefer. In addition, the board or a director may even engage in self-dealing transactions, subject only to the requirement that the transaction be fair to the corporation as an entity.⁴⁵

40. Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 614-15 (1998) ("The origin of the appraisal remedy typically is tied to the move in corporate law to majority approval of fundamental corporate changes, and away from a requirement of unanimous shareholder consent. When unanimous approval was no longer required, and shareholders effectively lost their individual right to veto corporate changes, the appraisal remedy was provided to them in return.").

41. See, e.g., *Hariton*, 188 A.2d at 125 (blessing merger and rejecting business purpose test and de facto merger doctrine). The Delaware Supreme Court blessed a transaction structured as an asset sale (where selling firm shareholders get no appraisal rights) instead of a merger (where they do). This particular ability to act in a way that is contrary to shareholder interests has not been accepted in all jurisdictions, even those with similar statutes, precisely because the act of disenfranchisement or disabling of important rights is viewed as antithetical to the fiduciary-based directorial mission. See CAL. CORP. CODE §§ 181, 1200, 1201, 1300 (West 2008) (creating voting and appraisal rights parity among different business combination transactions to discourage transaction design intended to limit statutory and common law rights of shareholders).

42. To cite just a few of the innumerable examples, a buyout may have severe tax consequences for minority shareholders or may deprive minority shareholders of potential appreciation in the firm's shares.

43. *Rothschild Int'l Corp. v. Liggett Group Inc.*, 474 A.2d 133, 136 (Del. 1984).

44. See, e.g., *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387 (N.Y. 1979). While inconsistent with traditional notions of fiduciary duty, these decisions likely vindicate the investor's ex ante bargain. See EASTERBROOK & FISCHER, *supra* note 7, at 119 ("If control transactions produce gains, and if the gains depend on unequal allocation, then the expected wealth . . . maximized by a rule allowing unequal allocation. All share prices *ex ante* will be highest when the probability of a value-increasing transaction in the future is the greatest.").

45. See, e.g., *Guttman v. Huang*, 823 A.2d 492, 502 (Del. Ch. 2003) ("In a typical

Shareholders may also waive their rights to the duties they are owed, something that sits uncomfortably with the notion of a fiduciary. The ability to waive is seen neither in the law of trusts nor in any other area where fiduciary duties have bite.⁴⁶ Indeed, several of corporate law's most famous cases are about explicit or implicit waivers of duties owed by directors or majority shareholders. For example, in *Ingle v. Glamore Motor Sales, Inc.*, Ingle was hired to run the firm and was appointed a director.⁴⁷ As part of his employment contract, Ingle agreed to sell back his shares to the firm if he left for any reason.⁴⁸ When Ingle was forced out many years later in a corner-office coup, he challenged his termination on the ground that he was, as a minority shareholder, owed a fiduciary duty by the firm and was protected against opportunistic conduct by them.⁴⁹ The court rejected his plea, holding in effect that whatever fiduciary duties Ingle was owed as a minority shareholder were waived through his employment contract.⁵⁰

Similarly, in *Gallagher v. Lambert*, an employee of a closely held firm entered into an employment agreement and a buy-sell agreement, which provided that for the first three years of his employment his shares would have to be sold back at book value.⁵¹ When the firm fired him just three weeks before the buyback period ended (taking about \$3 million in potential profits from him), the employee-shareholder sued, claiming a breach of fiduciary duty.⁵² The court rejected the claim. The shareholder had effectively waived his fiduciary duties by entering into the shareholder agreement—in other words, the parties' contract “define[d] the scope of the relevant fiduciary duty.”⁵³

Boards can engage in a variety of maneuverings with the corporate form that allow them to change the rights of shareholders in ways that may not be in

derivative suit involving a transaction between a director and her corporation, that director is interested because she is on the other side of the transaction from the corporation and faces liability if the entire fairness standard applies, regardless of her subjective good faith, so long as she cannot prove that the transaction was fair *to the corporation*.” (emphasis added)).

46. See DeMott, *supra* note 30.

47. 535 N.E.2d 1311, 1312 (N.Y. 1989) (“[The parties] entered into a written shareholders’ agreement which provided that . . . Glamore would nominate and vote Ingle as a director . . . of the corporation.”).

48. See *id.* at 1312 (“The agreement gave Glamore the right to repurchase all of Ingle’s stock if ‘Ingle shall cease to be an employee of the Corporation *for any reason*’ (emphasis added).”).

49. *Id.* at 1312-13.

50. See *id.* at 1313 (“A minority shareholder in a close corporation, by that status alone, who contractually agrees to the repurchase of his shares upon termination of his employment for any reason, acquires no right from the corporation or majority shareholders against at-will discharge.”).

51. 549 N.E.2d 136, 136 (N.Y. 1989).

52. *Id.* at 137.

53. *Id.*

the shareholders' financial interest.⁵⁴ For example, in a recapitalization, the board can, by creating a shell corporation with a new financial structure and then merging the old firm into the shell, eliminate a particular class of stock.⁵⁵ Firms may also reincorporate to a more management friendly state like Delaware, even if this is not in the interests of a particular class of shareholders.

Boards can also act in ways that are overtly beneficial to creditors, who in the traditional account are owed no extra-contractual duties and whose contract rights would seem to be trumped by any shareholder fiduciary rights. For one, creditors can bargain for voting trusts and thereby gain control of the board.⁵⁶ The whole point of such devices is to put in place directors who will not do what the shareholders want. A bankruptcy filing, which directors make and which destroys all shareholder value for the benefit of creditors, is just the culmination of creditor-preferring behavior.⁵⁷ This ability to control the shut-down decision sits uncomfortably with the claim that creditor-appointed directors cannot act in ways beneficial to those who put them on the board.

Existing law then leaves us in a peculiar place. As a general matter, shareholders lose when they complain about decisions of directors that are wealth-maximizing for the corporation as a whole, but contrary to the interests of the common shareholders. At the same time, however, courts continue to give lip-service to the idea that directors act for the benefit of the shareholders. Just last May, for example, the Delaware Supreme Court noted, "[t]he directors of Delaware corporations have the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners. Accordingly, fiduciary duties are imposed upon the directors to regulate their conduct when they perform *that* function."⁵⁸ Hence, courts are asked to reconcile a core

54. The ability of the board to engage in single-firm reorganizations or recapitalizations varies by state.

55. *See, e.g.*, Fed. United Corp. v. Havender, 11 A.2d 331 (Del. 1940) (permitting firm to eliminate preferred stock, and its dividend arrearages, through recapitalization).

56. This most commonly occurs in firms in financial distress, but nothing prevents this from being used in healthy or near-healthy firms. *See* Baird & Rasmussen, *supra* note 13, at 1215-17 (describing the control creditors exercise in financially distressed firms); *see also* M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1596 (2007) (same).

57. There are a few rare Chapter 11 cases in which shareholders do enjoy some recovery, but this remote possibility does not mean that the directors are somehow acting on the shareholders' behalf. In any event, in a perfectly standard prepackaged bankruptcy in which equity is wiped out, the directors approve a course of conduct that cannot possibly be in the shareholders' interests, yet no one suggests approving the filing of such a bankruptcy petition constitutes a violation of their fiduciary duties.

58. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (internal citation omitted). For an argument that the confusion generated by applying fiduciary duties to creditors justifies an elimination of all derivative rights of shareholders, *see* Ann E. Conway, *Trenwalla: A Call for Rationalizing Fiduciary Duties to Creditors in Delaware* (Widener Law Sch. Legal Studies Research Paper No. 08-09, 2007), available at <http://ssrn.com/abstract=991224>.

principle with accepted practices inconsistent with it.⁵⁹

B. *The Business Judgment Rule*

The business judgment rule is the crutch courts use most often to navigate around the maxim that directors owe a fiduciary duty to shareholders, at times in ways that distort the idea of fiduciary duty beyond recognition. One of the best known examples is the old chestnut of *Shlensky v. Wrigley*. The plaintiff challenged the Wrigley board's refusal to install lights at Wrigley Field, home of the Chicago Cubs baseball team, despite the fact that every other team played night games, and playing at night seemed to be the value-maximizing strategy.⁶⁰ Defendant board members did not argue that their actions were actually value maximizing for shareholders (say, through building a unique brand), but rather grounded their argument in the idiosyncratic preferences of Wrigley's majority owner—that baseball is a daytime game and that lights would hurt the surrounding community.⁶¹ The board effectively flaunted the fact that it was deliberately not trying to maximize shareholder value.⁶²

The court granted the board's motion to dismiss, establishing a strong business judgment rule that prevents plaintiffs from even inquiring into the rationale for the board's decision.⁶³ Plaintiffs got nowhere with their argument that directors were favoring others (in this case, non-investors like the game of baseball or the neighborhood, and certainly the idiosyncratic preferences of one shareholder) over shareholders.⁶⁴ Because of the business judgment rule, board

59. Another basis for the shareholder-only nature of fiduciary duties is that shareholder contracts, insofar as they exist, are more open ended and ambiguous than creditor contracts, and fiduciary duties are merely judicial gap fillers of contracts that would be too costly to write in detail. See EASTERBROOK & FISCHER, *supra* note 7, at 90-93. Judges are thus delegated the job of writing ex post contracts because writing them ex ante would be impossible or too expensive. This rationale, insofar as it obtains for shareholders, is becoming less unique to shareholders as credit derivatives and other financial innovations blur the lines between debt and equity. In other words, holders of debt are increasingly dispersed and disinterested in the way shareholders are, and credit contracts are containing fewer and fewer contractual restrictions and specifications. See Henderson, *supra* note 14.

60. 237 N.E.2d 776, 778 (Ill. App. Ct. 1968) (“[Compared to the Chicago White Sox, t]he weekend attendance figures for the two teams was [sic] similar; however, the White Sox week-night games drew many more patrons than did the Cubs’ weekday games.”).

61. *See id.* at 778 (“Wrigley . . . refused to install lights, not because of interest in the welfare of the corporation but because of his personal opinions ‘that baseball is a “daytime sport” and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood.”).

62. *See id.* (“It is alleged that he has admitted that he is not interested in whether the Cubs would benefit financially from such action . . .”).

63. *See id.* at 780 (stating that absent a showing of fraud, illegality or conflict of interest, a decision properly before the directors was “beyond [the court’s] jurisdiction and ability”).

64. STEPHEN M. BAINBRIDGE, *CORPORATION LAW & ECONOMICS* 245 (2002) (arguing that the plaintiffs’ inability to surpass a motion to dismiss shows that the business judgment

members also have the authority to donate to charity, which is one view of what Mr. Wrigley was doing, and take other actions that do not need to be justified in terms of shareholder wealth maximization.⁶⁵

The business judgment rule also gives boards wide latitude in determining what litigation is conducted by shareholders on behalf of the corporation. The rule permits boards, in most instances, to curtail litigation that might benefit shareholders. Boards enjoy near *carte blanche* to avoid derivative suits against the firm that might be in the interest of one class of stakeholders, say the shareholders, but contrary to the interests of another class, say the creditors, or vice versa.⁶⁶

Under the shield of the business judgment rule, the board can even take actions that deliberately benefit creditors at the expense of shareholders, so long as the decision is based in facts, well considered, in good faith, and not conflicted by any personal interests of a majority of directors.⁶⁷ Even decisions that seem plainly to hurt shareholders are protected by the business judgment rule, as long as the procedural predicates are met.⁶⁸

As one court noted, the business judgment rule “bars judicial inquiry into actions . . . in the . . . legitimate furtherance of corporate purposes.”⁶⁹ The important pressure point here is the word “corporate,” which speaks to the value of the corporation as a whole, as opposed to the value of its constituent parts. A leading commentator defines fiduciary duties as “a bargained-for term

rule is an abstention doctrine—that courts don’t even inquire into business decisions that are made in good faith).

65. *See, e.g.*, *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581 (N.J. 1953) (refusing to review gift to Princeton University by small manufacturing company whose CEO was an alumnus). Of course, charitable contributions and other such actions could be justified on shareholder wealth maximization grounds, such as building brand or employee loyalty, but the law does not require this. For example, Delaware empowers boards to donate to charity without regard to its purpose. *See* DEL. CODE ANN. tit. 8, § 122(9) (West 2008) (“Every corporation created under this chapter shall have power to: . . . (9) Make donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof . . .”).

66. While the demand-requirement process is complicated, the practical essence is that well-advised plaintiffs do not make a demand in a derivative case. Making demand is an admission that demand is required, and the board may refuse demand under the shield of the business judgment rule. So if the plaintiffs make a demand, they lose, even if the lawsuit is fairly clearly in the best interests of shareholders. In almost all cases, therefore, plaintiffs will plead that demand was futile, alleging that the board was interested, tainted by a dominating shareholder or director who has a conflict, or the board is otherwise incapable of making a decision that is in the best interest of the corporation. *See, e.g.*, *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996).

67. *See* BAINBRIDGE, *supra* note 64, at 414-15 (discussing state stakeholder constituency statutes).

68. *See, e.g.*, *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976) (holding that director decision to distribute dividend of subsidiary stock was protected by the business judgment rule, despite the fact that the firm retaining the stock and marking it to market would have saved shareholders about \$8 million).

69. *Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979).

of the board-shareholder contract by which the directors agree not to make Kaldor-Hicks efficient decisions that leave shareholders worse off.”⁷⁰ But the business judgment rule in operation is plainly inconsistent with this definition. Indeed, applying this conception of the business judgment rule, even with a highly deferential standard of review, would unsettle many well-established practices.

The business judgment rule, however, is an awkward tool for giving directors the legal guidance they need to make good decisions. Deferring to the directors’ judgment is not the same as acknowledging that under some circumstances the proper decision runs counter to the shareholders’ interests. Among other things, many directors want to do what they are supposed to do. That the business judgment rule would protect them even if they did something that ran counter to their duties is not what matters to them.

Moreover, the business judgment rule invites circumlocution. Consider directors who make a decision they believe is in the best interest of the corporation as a whole (and consistent with the investors’ ex ante bargain) but contrary to the interests of shareholders. Given the fiduciary duty maxim and its pervasiveness, overt recognition by the directors that they are not acting in the interest of shareholders is best avoided. Instead of clear-headed analysis, discussion becomes couched in terms that are somewhat tortured, but less likely to make waves. This phenomenon has unfortunately become all too common in many areas of corporate law.⁷¹ Turning board meetings into games in which many actions are taken and much money spent merely to give legal cover to decisions is wasteful and erodes confidence in law and process in general. In addition, directors may come to believe that the games are real, which may lead them to take actions that destroy firm value.

II. A DUTY TO MAXIMIZE FIRM VALUE

In recent years, courts have been forced in some cases to retreat from the traditional account of fiduciary duties being owed exclusively to shareholders.⁷² For the most part, they have tried to do this by finding fiduciary duties are sometimes owed to others.⁷³ The facts of *In re Central Ice Cream*

70. Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 359 (2007).

71. In one of corporate law’s most famous cases, the Delaware Supreme Court held directors personally liable for agreeing to sell a struggling firm in a terrible industry at a huge premium for shareholders. *See Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). The lesson for directors from such cases is not to reject similar deals when they come along, but to go through the motions of getting advice from bankers and lawyers, shopping the firm to other buyers, and acting in the ways that the law says they must.

72. For a recent discussion of the issue, see Cory Dean Kandestin, Note, *The Duty to Creditors in Near-Insolvent Firms: Eliminating the “Near-Insolvency” Distinction*, 60 VAND. L. REV. 1235 (2007).

73. *See, e.g., Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, No.

Co. provide an excellent illustration of the problem the courts have faced and how they have confronted it.⁷⁴

The Central Ice Cream Company owed its general creditors about \$12 million.⁷⁵ It had closed its doors, and its only asset was a lawsuit against McDonald's. Central Ice Cream prevailed at trial and received a \$52 million judgment. At this point, McDonald's made a settlement offer of \$16 million. The general creditors, as one might expect, wanted it accepted post haste. If Central Ice Cream took the offer, they would be paid in full. By contrast, if Central turned it down, the judgment might be reversed on appeal and leave them with nothing. The shareholders, again none too surprisingly, wanted the offer rejected. They would receive only \$4 million if the settlement offer were accepted, but they would get more than \$40 million if Central Ice Cream refused to settle and ultimately prevailed on appeal. Getting the \$40 million was not certain, but risking \$4 million to get \$40 million with reasonable odds is a good bet.

Neither the shareholders nor the creditors of Central Ice Cream are the residual claimants over all dimensions. More importantly, neither group will act with the interest of the other in mind. To see this clearly, tweak the facts slightly and assume that the settlement offer was for exactly \$12 million. If each type of investor cared only about its own economic interests, the creditors would accept the offer and the shareholders would reject it, regardless of the company's chances of prevailing in the end.

For the judge who had to confront this problem (Frank Easterbrook), there was an easy answer. Central Ice Cream was in bankruptcy, and bankruptcy law requires the trustee to maximize the value of the estate. Hence, she need only assess the settlement offer on its merits. If, for example, the settlement offer were for exactly one quarter of the judgment, she need ask simply whether Central Ice Cream has a better than twenty-five percent chance of prevailing on appeal.⁷⁶ *In re Central Ice Cream* does not speak directly to directors' obligations outside of bankruptcy. Nevertheless, Judge Easterbrook's opinion sends a strong message cautioning against considering only the interests of shareholders in corporate decisionmaking, and the Delaware chancellors listened.⁷⁷

Civ. A. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

74. *In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987).

75. This hypothetical has been one of the central fixtures of corporate law over the last decade. It is set out in *Credit Lyonnais*, 1991 WL 277613, at *34 n.55.

76. We are oversimplifying here, of course. We assume that the appeal is an all-or-nothing affair and that there are no costs associated with such an appeal. These do not change the underlying problem.

77. The evidence for this is indirect. The Delaware courts have not cited *In re Central Ice Cream*, but merely converted its facts into a hypothetical (including numbers that make it extremely unlikely that it was a mere coincidence). For his part, while long a major voice in corporate law, now-Chief Judge Easterbrook has never shown any sign he is even aware of the controversy *In re Central Ice Cream* has spawned.

Several years after *In re Central Ice Cream*, a Delaware chancellor in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* considered the *In re Central Ice Cream* problem and suggested that in such situations, those in which the business is in the “zone of insolvency,” the duties of the directors run to the creditors as well as to the shareholders.⁷⁸ Hence, directors who use their best judgment do not violate their duties even if the decision favors creditors at the expense of shareholders: “At 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.”⁷⁹ The court posited a set of facts like those in *In re Central Ice Cream* and explained:

[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 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.⁸⁰

The difficulty—one that the courts have wrestled with ever since *Credit Lyonnais*—is making operational sense of this observation.⁸¹ Assume, for example, that McDonald’s puts on the table a settlement offer that is less than what the creditors are owed. Can a director reject it out of hand on the ground that it leaves the shareholders with nothing? The Delaware Supreme Court decided this year that creditors never have a direct action in such a case, but it left the door open for allowing them to bring a derivative action against such a director.⁸²

The ability of creditors to bring an action against the directors, however, is

78. The court was not writing on an entirely blank slate. Before *Credit Lyonnais* courts had previously noted that the duty of the directors shifts to creditors when the corporation is insolvent. See, e.g., *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982); *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945). This doctrine had (and continues to have) little bite in practice both because of the business judgment rule and because it is usually hard to tell whether a firm is in fact insolvent.

79. *Credit Lyonnais*, 1991 WL 277613, at *34.

80. *Id.* at *34 n.55.

81. For an analysis of the way *Credit Lyonnais* redirects the board’s focus without actually imposing legal liability, see Jonathan C. Lipson, *The Expressive Function of Directors’ Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224 (2007).

82. See *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007). Of course, only directors who are extremely badly advised can ever be tagged with liability. As long as the directors go through the motions and assert that they assessed the settlement offer in light of the interests of everyone, they will be protected by the business judgment rule.

not the question that courts usually confront when the interests of both creditors and shareholders are implicated. The facts of *Credit Lyonnais* present the problem in its typical form. MGM-Pathe Communications, the defendant in the case, found itself in difficult financial straits. The firm-saving deal ultimately reached between the banks and the principal shareholder excluded the latter from exercising control rights until a specified amount of debt was paid down. This shareholder urged the directors to sell enough of the assets of the business to return him to power. The directors refused on the ground that the sale of assets was not in the interests of the corporation as a whole.

The creditors had no need to call upon courts to ensure that the directors paid attention to their interests. They had set things up so that the directors would look out for them—provided that a court did not interfere.⁸³ To protect the creditors' interests—and to vindicate the ex ante bargain—the court needed only a reason to refrain from acting. Instead of seeking to impose liability on the directors, the creditors wanted to ensure that liability would not be imposed on the directors for decisions that favored them. In other words, fiduciary duties to shareholders stood in the way of free and efficient contracting.

By asserting that fiduciary duties turn on the identity of the residual claimant (and that creditors are therefore also owed duties when the firm is in the “zone of insolvency”), a court avoids having to use the business judgment rule in circumstances when a decision, however sensible, is transparently contrary to the interests of the shareholders. It is, however, far from being a satisfactory solution to the problem. One cannot simply transplant the duties ordinarily owed to shareholders to creditors even when they are unambiguously the residual claimants. The positions of creditors and shareholders are not the same. They typically enjoy radically different control rights, different information, different bargaining positions, and different risk profiles. Hence, we should not assume that the running default obligations of directors to creditors parallel to those owed to shareholders is value maximizing ex ante.⁸⁴

Most of those who attack *Credit Lyonnais* have failed to appreciate the dynamic the court confronted. The creditors were not asserting that the directors owed them a duty, merely that notion of fiduciary duty owed to shareholders should not prevent the directors from taking actions that were in the creditors' interest and in the interest of the firm as a whole. When creditors are the residual owners, they do not need the affirmative protection of fiduciary

83. For an argument that contract can serve the same function as proposals to expand fiduciary duties to creditors, see Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors* (Emory L. & Econ. Research Paper No. 07-24, 2008), available at <http://ssrn.com/abstract=1031242>. See also Simone M. Sepe, *Directors' Duty to Creditors and the Debt Contract*, 1 J. BUS. & TECH. L. 553, 562 (2007) (arguing for a contract-based view of duties to creditors).

84. See Kelli A. Alces & Larry E. Ribstein, *Directors' Duties in Failing Firms*, 3 J. BUS. & TECH. L. (forthcoming 2008) (arguing that there are no director fiduciary duties in the zone of insolvency, and that all of the cases supposedly so holding can really be explained by the business judgment rule).

duties. It suffices if the law merely allows the contractual mechanisms they put in place to operate effectively, and contractual mechanisms can operate effectively, as long as courts do not create duties that interfere with them. Contracts are, of course, incomplete, and judges must fill in gaps, but they should not invoke fiduciary duties to fill them. Fiduciary duties have the effect of resolving ambiguity in favor of whoever is the beneficiary of the fiduciary duty and, in the abstract, there is no reason to think that this advances the parties' interests.

This observation suggests that corporate law should follow the lead of Judge Easterbrook in *In re Central Ice Cream*: The duties of the directors should go towards all the investors as a group, that is, to the firm.⁸⁵ Their duty is analogous to the principle in the law of trusts known as "the duty of impartiality." This is a duty that pushes trustees in the direction of considering the trust as a whole: *A* creates a trust where the income is to be distributed to *B* during her lifetime, with the principal distributed to *C* upon *B*'s death. The trustee has duties running to both beneficiaries and their interests conflict.⁸⁶ The trustee may, for example, be forced to choose between an investment that offers high current income and one that offers long-term growth.

Other things equal, the trustee should try to maximize the value of the trust as a whole. In the case of trusts, other things are often not equal. If *B* is an elderly widow and *C* an entirely self-sufficient adult child, the trustee would be remiss if the trust generated no current income, even if this course would maximize the expected value of the trust. Maximizing value under these circumstances runs counter to any sensible interpretation of the settlor's intent. The law of trusts does not require the trustee to act robotically or without regard to the particular needs and interests of those for whom she is taking care. Rather the trustee's obligation is to "act impartially and with due regard for the diverse beneficial interests created by the terms of the trust."⁸⁷

85. Judge Easterbrook, of course, was not expressly setting out this idea as a principle of corporate law. As noted, *In re Central Ice Cream* is a bankruptcy case. Moreover, as a sitting judge of an inferior federal court, Easterbrook's views on first principles of state corporation law would not be binding in any event. The idea is not also an entirely new one. The U.K. Companies Act of 2006 provides that directors are obligated to "promote the success of the company for the benefit of its members as a whole." Companies Act 2006, c. 46, § 172(1), available at http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_1.

86. See AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHER & MARK L. ASCHER, SCOTT AND ASCHER ON TRUSTS § 17.15, at 1259, § 20.1, at 1462 (5th ed. 2007). There is a related literature on common agency. See also *supra* note 29.

87. RESTATEMENT (THIRD) OF TRUSTS § 79(1)(a) (2007). An interesting modern example is the battle for control of Dow Jones, Inc., the publisher of, among other things, the *Wall Street Journal*. Media mogul Rupert Murdoch made a bid for Dow Jones at \$60 per share in cash (it was trading at about \$34 before the offer). The complication was that about sixty-four percent of Dow Jones shares were held in various trusts for descendants of the Bancroft family. Some of the family members—the young ones generally—preferred the cash, while other family members—the old ones generally—valued the "journalistic integrity" of the paper, so objected to it falling into the hands of the controversial Mr.

In the corporate context, it might seem that such complications do not enter the picture. Maximizing the value of the firm as a whole provides a suitable benchmark. Investors can diversify their portfolios to protect themselves in the event maximizing firm value turns out to favor one class of investors over another.⁸⁸ This idea, of course, should not give courts broad license to second-guess the directors' decisionmaking. A court after the fact may have no easy way to tell whether the directors in fact used their best judgment to maximize firm value. A director may not perform as well if she must worry whether each decision maximizes firm value.⁸⁹ Hence, there should also be a relatively forgiving business judgment rule. In law-and-economics circles, this is probably the conventional wisdom and indeed coupling firm-maximization with a broad business judgment rule may in fact be a sensible way to think about the problem, but as we discuss in the next Part of the paper, it is not the only way.

III. A CONTRACTARIAN SOLUTION

In the last Part, we suggested that corporate law might sensibly adopt the principle that directors owe a fiduciary duty to the corporation as a whole. They are obliged to make decisions that maximize the value of the entire pie, not any particular slice. The exact contours of the duty turn in some measure on how the business judgment rule is applied, but the benchmark is easy to state. In this Part, however, we suggest that this conception of directors' duties is far from self-evident. Among other things, it seems inconsistent with important features

Murdoch. *See, e.g.*, Tim Arango, *Shaking the Bancroft Family Tree*, FORTUNE, May 28, 2007 (describing generational split). In this case, the conflicting issue for the trustee is not different monetary valuations, but money versus idiosyncratic preferences. We cannot imagine the law doing much here, short of holding that trustees, like directors, must show up, work hard, and not line their own pockets.

88. *See* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999). Smith argues that since investors are presumed to hold a market basket of securities, the average investor's portfolio will have the same equity holdings to debt holdings ratio as the average equity to debt ratio in the capital structure of firms. Accordingly, an investor who loses as a shareholder in one firm will make it up as a debt holder in that firm or in the fortunes of another firm. Alon Chaver and Jesse Fried add an important coda to Smith's argument, noting that "performance creditors," that is, those owed contractual performance instead of cash, should be considered in any analysis of fiduciary duties. Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813 (2002).

89. This is just a standard observation about agency costs. Any mechanism put in place to ensure that the value of the firm is at all times optimized comes at some cost. Everyone may be better off *ex ante* if someone with expertise has discretion even if her incentives distort decisionmaking to some extent. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

of standard venture capital contracts.⁹⁰ These contracts are especially illuminating. They are heavily negotiated by informed and sophisticated parties, are made in a highly competitive environment, and are extremely specific about the allocation of control rights at a time in the firm's life—its formation—when these issues are crucial.⁹¹ *Orban v. Field*, illustrates the problem of applying fiduciary duties to the firm as a whole.⁹²

In *Orban*, the court considered an allegation of a breach of fiduciary duty brought by a shareholder who claimed the board, dominated by preferred shareholders, favored their own interests at the expense of common shareholders.⁹³ Office Mart, the firm at issue in the case, was a big-box supplier of stationery supplies that tried to expand its operations and failed. The board backed a merger transaction with office supply giant Staples, but the amount realized from the sale was not enough to satisfy the liquidation preferences of the preferred stockholders. As a result, if the deal went through, the common stockholders would get nothing.

Staples required that the merger be approved by over ninety percent of Office Mart shareholders. To make this possible, the Office Mart board gave cash to its preferred shareholders to buy warrants to dilute the common shareholders below ten percent, thus ensuring approval of the merger. The largest common stockholder brought suit against the directors, pointing out that this action on the part of the directors, along with others, had the effect of bringing about a transaction that wiped out his interest entirely and therefore violated the duty they owed him. Moreover, the directors themselves were holders of preferred stock and stood to benefit from the transaction with Staples. Hence, they violated their duty of loyalty as well as their duty of care, and the business judgment rule was therefore unavailable. Nevertheless, the court upheld the board's actions. In doing so, it had to acknowledge that a board could indeed take actions (such as implementing a change in the corporate charter needed to accommodate the prospective buyer) that were manifestly contrary to the interests of the principal common shareholder:⁹⁴ "A board may certainly deploy corporate power against its own shareholders in some circumstances—the greater good justifying the action—but when it does, it should be required to demonstrate that it acted both in good faith and reasonably."⁹⁵

90. See Barlett, *supra* note 21, at 83-90 (discussing the conflict created by down-round financing in venture capital contracts).

91. The other crucial time in a firm's life is its death, and financial distress raises the same issues. Not surprisingly, venture capitalists and entrepreneurs have a firm's death in mind when bargaining for control rights at firm creation.

92. No. 12820, 1997 Del. Ch. LEXIS 48 (Del. Ch. Apr. 1, 1997).

93. *Id.* at *2-3 ("[Plaintiffs' claim] asserts that the board, which was controlled by holders of preferred stock, exercised corporate power against the common and in favor of the preferred and, thus, breached a duty of loyalty to the common.").

94. See *id.* at *29.

95. *Id.*

The court grounded this decision—that the board had acted in good faith and in reasonable way—in part on the fact that the preferred shareholders were themselves not being paid in full. Of course this should not be sufficient, or maybe even relevant. Even though the preferreds were taking something of a hit by selling immediately, their incentives were still distorted. An immediate sale always involves trading off the costs of waiting with the prospective benefits. The preferreds suffered all of the former, but reaped only a small part of the latter. Merely observing that they enjoyed *part* of the upside does not tell us whether they made the proper decision.

There were facts in *Orban* that made things easier for the court. The principal shareholder did not dispute that the transaction was in fact the best course for the corporation as a whole.⁹⁶ The number of prospective buyers (other big-box office supply stores) was small, so the deal may have been one of last resort. Moreover, the common shareholder seems to have acted badly. The shareholder gave his implicit support for the deal, only to withdraw it later merely in an effort to extract some of the purchase price from the preferreds.⁹⁷

The willingness of the court to stand behind the directors in *Orban*, however, makes sense without any of this. Office Mart had a governance structure that, like most venture-backed deals,⁹⁸ departed dramatically for the typical one in which power is centered on the common shareholders. One explanation is that venture capitalists generally own preferred as well as common stock (or various convertible varieties thereof), while the entrepreneur/founder has only common stock.⁹⁹ In addition, preferred as well as common stockholders vote. Hence, when the venture capitalist controls the majority of the preferred and common combined, the levers of power are in the hands of senior investors, even though they are not the residual owners of the business. Venture capital contracts take other forms as well, but they do share one essential feature. When firms are distressed (whether they are insolvent, near insolvent, or not), control always resides with the senior owner, not the

96. *See id.* at *26 n.23 (“There is no claim that . . . the merger . . . was not in the best interests of the corporation.”).

97. *See id.* at *22 (“[I]t is clear that negotiations ensued in which Mr. Orban attempted to extract a payment of \$4 million from the company in exchange for his agreement to support the merger.”).

98. For a general discussion of venture capital structures and exit strategies, see D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315 (2005). More and more firms are seeing radical changes to their financial structure as a result of the surge in private equity investments and going-private transactions. (In terms of the corporate finance issues discussed herein, venture capital and private equity investments are similar.) The problems of senior investors holding tranches of debt and equity, along with board seats, conversion rights, and other contracted-for rights, participating with common shareholders is likely to become much more common in light of these trends.

99. One of these reasons is tax. *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 984-86 (2006) (“[T]he use of preferred stock rather than common stock can reduce the tax cost of equity-based incentive compensation given to founders and other employees of the startup.”).

residual owner. Giving the venture capitalists or other senior investors the ability to pull the plug in bad states of the world is an unambiguous part of the ex ante investment contract.

This governance structure comes with an obvious downside. A board that acts on behalf of a senior investor will tend to play it safe. Directors will resist taking on new projects or even agreeing to keep the firm operational, as they enjoy none of the upside and suffer the consequences if things go badly.¹⁰⁰ In a case such as *Orban*, we can see how this may distort decisionmaking. The business was worth enough to pay the preferred shareholders more than ninety percent of what they were owed if sold immediately.¹⁰¹ From the perspective of the preferred stockholders, the additional energy and monies spent on finding a buyer would not be well spent. They faced all the downside from waiting, while someone else (the principal common shareholder) would enjoy most of the upside. Of course, the principal common shareholder took the opposite view. He had nothing to gain from the sale, so waiting for a better offer could only make him better off.

In venture capital deals, everyone begins knowing that things may not work out and the time to shut down or sell out may come. And, as discussed above, no one type of investor has perfect incentives. Nevertheless, someone must be able to make this decision, even though no one's incentives are perfectly aligned. The deals struck suggest that the comparative advantage belongs to the venture capitalist. They always retain control over the shutdown decision in bad states of the world. Venture capitalists are repeat players and they may be best able to decide when to pull the plug, notwithstanding their skewed incentives.¹⁰² In light of this contracting regularity, it would seem odd

100. See Smith, *supra* note 98.

101. See *Orban*, 1997 Del. Ch. LEXIS 48, at *23-24 (“[T]he company extended sufficient consideration to the Series C holders (\$3,013,995) to enable them to exercise warrants to permit them, as a group, to hold more than 90% of Office Mart’s outstanding common stock.”).

102. Consider the launch of Apollo 12. Lightning struck the rocket carrying the Apollo 12 module shortly after takeoff causing the computers on board to shut down. In such situations, those in control must both look for a solution and decide how long to look before aborting the mission. The abort switch was entrusted to Pete Conrad, the commander of the mission. He did not know how to fix the problem, but he waited long enough for a steely-eyed ground controller to suggest a fix and fellow astronaut, Alan Bean, to implement it. See *Apollo 12 Lightning Strike*, <http://www.aerospaceweb.org/question/spacecraft/q0140.shtml>. Conrad’s incentives to abort the mission at the optimal time were not perfect. He was not perfectly informed and did not completely internalize all the interests at stake. We can imagine elaborate, theoretically more perfect alternatives such as a voting mechanism among the astronauts or by mission control executives or engineers, carefully calibrated according to experience, perspective, optimism, dispassion, residual loss bearers, information, and so on. But simple solutions sometimes work best. Putting the abort switch in the hands of the mission commander worked in this instance and may have been the best choice under all the circumstances. In the corporate environment, there also needs to be some mechanism to ensure the shutdown decision is made optimally, and here too simple, imperfect solutions may work best. Although stories could be told about why one decision mechanism or

for courts to stand in the way.

Orban seems to stand for the proposition that directors can take actions that are in the best interests of the corporation as a whole even when they take actions that are manifestly self-interested or favor non-fiduciaries over fiduciaries.¹⁰³ But to take advantage of this rule, the directors may be forced to show the “entire fairness” of the transaction to the corporation as a whole.¹⁰⁴ It is consistent with the idea that directors should make decisions that are value maximizing ex post.

But this may not get things quite right. The founders of the firm take an equity stake, which in most cases gives them an incentive to manage well, but giving venture capitalists an option to exercise control rights in some bad states of the world, even when their exercise would destroy firm value, may give the founders or their agents an extra incentive to do well. In other words, selfish control rights may be given to senior claimants to give junior claimants (including shareholder-managers) an added motivation to avoid bad states of the world.

This theory is supported by other contracts we observe. Well-established models of debt posit that loan covenants serve as trip wires.¹⁰⁵ If actually tripped, value is lost, but the trip wires need to exist in order to give those in control the right incentives. It is but a small step to recognize that when senior investors succeed to control, they will also act in a way that is not necessarily value maximizing ex post. No one doubts that loan covenants, even those that are value-reducing ex post, should be enforced and that they may in fact vindicate the ex ante bargain. The exercise of control rights by senior investors may operate in the same way.

While this is certainly a plausible explanation, we need not know the exact reason why we see these control rights to presume that they are efficient. The fact that they are ubiquitous and have persevered in a highly competitive industry is enough to give corporate law pause before disrupting them. Whatever the reason for their existence, the evidence suggests that the venture capitalists bargained ex ante to act in the way the preferred shareholders did in *Orban*, without answering the question of whether the deal they struck was

another is preferable, outsiders should be careful about meddling in the choice of experienced professionals and should be very leery about writing rules that inhibit choice. Although the analogy here is imperfect, it shows how decision rules are complex and difficult to unpack from all of the other elements of a successful space (or corporate) endeavor.

103. See *Orban*, 1997 Del. Ch. LEXIS 48, at *29.

104. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d. 701, 710 (Del. 1983) (requiring defendants in entire fairness inquiry to show that the transaction in question was entirely fair to the corporation).

105. See, e.g., George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1093 (1995) (arguing that loan covenants “serve as trip wires for the lender’s right to . . . enforce or to intervene in the borrower’s decisions”).

value maximizing for the firm as a whole.¹⁰⁶ Giving senior investors control rights at certain times may be efficient, even if they use these rights to serve their selfish ends at the expense of firm value. The granting of this real option to creditors may create just the right incentives for shareholder managers to operate the firm efficiently in the first place.

The ability to put in place directors who would engage in a sale that suited the interests of the preferred stockholders is not different from a secured creditor who bargains for the right to repossess collateral in the event of default and who can exercise that right without having to show that it is value maximizing *ex post*. The founders and common shareholders agreed that if things went well, they would all get rich, but if things went badly, the investors would come first. Imposing fiduciary duties in this environment, even one that imposed a duty to the corporation as a whole and that came with a generous business judgment rule, is a potential source of mischief.

IV. APPLICATION: DELINKING DISCLOSURE DUTIES

Ridding corporate law entirely of the idea of fiduciary duties would force the reconceptualization of a number of features of the law in ways that are potentially healthy. We consider one of these here—disclosure. Under current law, directors' disclosure obligations are tied inexorably to their fiduciary duties. Hence, material nonpublic information must be disclosed when transacting with shareholders, but not with creditors. As financial innovation makes the difference between debt and equity less important, this distinction is becoming increasingly hard to justify. A more sensible approach is one that decouples the disclosure obligations from other duties and also makes it easier for sophisticated professionals both to opt out of disclosure obligations and opt into them.¹⁰⁷ Fiduciary duties restrict free contracting in ways that are plainly

106. This, of course, does not excuse some types of self-dealing on the part of the venture capitalist or any other senior investors. Consider the following scenario: The venture capitalist makes an initial investment in a startup, taking convertible preferred shares and a board seat. The venture capitalist board member dominates the board, reassuring other directors that funding options are abundant, while encouraging profligate spending, and all the while knowing that turning away deals is going to force the firm into desperation, and thereby forcing the firm to agree to additional financing from the venture capital firm on onerous terms. The venture capital firm arranges a bridge loan to the firm, taking nearly free warrants that dilute entirely the value held by common shareholders. If the common shareholders could show that the deals the venture capitalist board member turned away were legitimate, that the board process was insufficient, and that the board was dominated by a director with a conflict of interest, it could overcome *Orban*, since the transaction in question was not the final deal, but the entirety of the firm's search for financing.

107. Easterbrook and Fischel reach a similar conclusion, albeit for different reasons. See EASTERBROOK & FISCHEL, *supra* note 7, at 269-70 (“‘Fiduciary duties’ are a questionable basis on which to distinguish insiders from others. . . . It is not at all clear that the distinction between ‘insiders’ and ‘outsiders’ matches the class of trades that would be prohibited by contract . . .”).

inefficient.

A. *Disclosure Duties*

The classic common law case on disclosure obligations is *Goodwin v. Agassiz*.¹⁰⁸ In this case, the plaintiff learned negative news about the prospects for a mining company from a newspaper article, while two directors learned positive news from a confidential (that is, non-public) geological report.¹⁰⁹ The directors bought shares through a broker on a stock exchange. The positive news eventually became public and the stock rose. The seller of the stock that the directors had acquired sued. He claimed that, because he was a shareholder at the time of the sale, the directors owed him a fiduciary duty and precluded them from trading with him when they possessed material information he did not.¹¹⁰

The court rejected the claim. It distinguished the actions of the directors under these facts from the situation in which they had sought out the shareholder or where the corporation was obliged to disclose the information to the shareholders as a group:

An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules.¹¹¹

In recent decades, however, the law evolved in a different direction. In a case with facts quite similar to *Goodwin*, the SEC brought an enforcement action against executives of a mining firm who traded on an anonymous stock exchange with investors who were at the same informational disadvantage—they did not know that a large ore deposit had been discovered on land that the firm was buying from unsuspecting farmers.¹¹² The Second Circuit found the directors liable to the sellers of the stock, on the ground that the securities laws

108. 186 N.E. 659 (Mass. 1933).

109. *Id.* at 659 (“They had certain knowledge, material as to the value of the stock, which the plaintiff did not have.”).

110. *Id.* at 660 (“The contention of the plaintiff is that the purchase of his stock in the company by the defendants without disclosing to him as a stockholder their knowledge of the geologist’s theory . . . constitute actionable wrong for which he as stockholder can recover.”).

111. *Id.* at 661. The U.S. Supreme Court endorsed the rule that a disclosure obligation may exist in face-to-face transactions in *Strong v. Repide*, 213 U.S. 419 (1909). The minority rule prevalent in a handful of states is that directors have a duty to disclose all material information to shareholders before trading with them. *See, e.g.*, *Oliver v. Oliver*, 45 S.E. 232 (Ga. 1903) (holding that a director must always disclose material facts when trading against a shareholder).

112. *See SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

intended “that all members of the investing public should be subject to identical market risks” and that investors had to trade “on an equal footing” with each other.¹¹³

Several years later, the United States Supreme Court (with the help of then Deputy Solicitor General Frank Easterbrook)¹¹⁴ recognized that requiring everyone to trade “on an equal footing” with one another cut much too broadly.¹¹⁵ Congress could not have intended “a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.”¹¹⁶ Markets exist only if those with information are able to profit by trading on it.¹¹⁷ Moreover, trading by those with information brings the market into equilibrium and ensures that prices more accurately reflect underlying values.

To cabin the reach of disclosure obligations under the securities laws, Justice Powell tied them to fiduciary duties: “Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”¹¹⁸ He therefore found that a failure to disclose inside information triggered liability only if there were a duty to speak and this duty exists only “when one party has information ‘that the other . . . is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.’”¹¹⁹

113. *Id.* at 852.

114. Instead of relying on the broad grounds on which the government had won below, Easterbrook pressed for a conviction based on Chiarella’s misappropriation of inside information. Brief for the United States at 70-71 n.48, *Chiarella v. United States*, 445 U.S. 222 (1980) (No. 78-1202). Easterbrook’s name does not actually appear on the brief, as he left the Solicitor General’s office just before it was filed. (The brief was filed in early August 1979 and Easterbrook departed in July of the same year. See Curriculum Vitae of Frank H. Easterbrook, <http://www.law.uchicago.edu/faculty/easterbrook/cv.html>.) But Easterbrook’s portfolio up until the time he left included all economic matters, and his fingerprints on the brief are manifest to anyone familiar with his work. See, e.g., Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 314-17. While the government did not prevail on Easterbrook’s misappropriation theory, the government’s brief did direct the Court away from an inappropriately broad view of insider trading. *Chiarella*, 445 U.S. at 233 (“Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent.”).

115. 445 U.S. at 233.

116. *Id.*

117. No one invests in gathering information about securities if they cannot profit from trading on it. See, e.g., HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) (arguing that insider trading laws reduce incentives for investing in information about firm value).

118. 445 U.S. at 234-35.

119. *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). As the law has later developed, liability can also exist even if the person who trades violates a fiduciary duty he owes to someone other than the person with whom he is trading. See *United States v. O’Hagan*, 521 U.S. 642, 655 (1997) (applying misappropriation theory). For example, an employee who learns that his company is about to make a tender offer violates

Over time, a tighter link between disclosure obligations and fiduciary duty has displaced the “practical rule” established in *Goodwin*.¹²⁰ Under modern securities law, we can be fairly certain that if the corporation is in possession of information about the business that is material and nonpublic, it cannot engage in equity trading without disclosing it. Directors (acting for the firm) owe the firm’s existing shareholders fiduciary duties and therefore cannot disadvantage them for the benefit of the directors or even the firm. By contrast, a corporation is under no obligation to disclose information to strangers (such as the unsuspecting farmers who sell the mineral rights in the first instance).¹²¹

Although perhaps helpful in steering the SEC away from its extreme position, the linkage between disclosure and fiduciary duties produces odd results. Judge Easterbrook’s opinion in *Jordan v. Duff and Phelps, Inc.* is a prime example.¹²² In *Jordan*, a resignation by the plaintiff led to a fairly simple contract dispute about a shareholder agreement between a closely held firm and the plaintiff, who owned a few shares. The issue was whether the firm had to disclose information about inchoate merger negotiations when it bought back shares pursuant to the shareholder agreement, even though it made no promises to do so and the parties agreed on a set price for buy-back of the shares. The court found a duty to disclose based on the syllogism: the employee was a shareholder, shareholders of firms are owed fiduciary duties, and holders of fiduciary duties are owed disclosures that others aren’t. As discussed at length elsewhere, this conflation of fiduciary duties and disclosure is suspect and leads to smallish state law contract cases becoming federal disclosure cases, as well as potentially disrupting free contracting for investors and firms great and small.¹²³

The tight linkage between disclosure obligations and fiduciary duties carries with it the implication that directors do not have disclosure obligations towards creditors, who are not owed fiduciary duties generally. This is again almost right. Requiring disclosure to creditors as a general matter surely cuts too far. It is almost impossible to enter into an economic relationship of any consequence without creditor-debtor relationship arising. A steady supplier who sells on open account is a creditor, as is a customer who makes a deposit. It is but a short step from imposing an obligation to disclose to creditors to making an obligation to disclose to everyone. But what if a corporation in financial distress seeks to borrow additional money from an existing creditor

10b-5 if he violates his obligations to his employee and purchases stock of the target. *See id.* This source of liability is not relevant to our discussion here.

120. *Goodwin v. Agassiz*, 186 N.E. 659, 661 (Mass. 1933).

121. *See Laidlaw v. Organ*, 15 U.S. 178 (1817) (holding that contracting party had no duty to disclose material fact—in this case, the end of the War of 1812—to a stranger on the other end of the bargain).

122. 815 F.2d 429 (7th Cir. 1987).

123. *See* M. Todd Henderson, *Deconstructing Duff and Phelps*, 74 U. CHI. L. REV. 1739 (2007).

who is, by any measure, a major stakeholder? In such cases, are they obliged to be more forthcoming than they would be to a complete stranger?

B. Big Boys and Anti-Big Boys

The rise and collapse of Global Crossing raised precisely this issue.¹²⁴ Global Crossing was formed in 1997 to close one of the last gaps in the Internet. The telecommunications cables connecting the continents were too small to accommodate the expected growth in Internet use outside of North America. In 1997, those outside North America accounted for only twenty percent of Internet use. By 2000, they were expected to account for almost half.¹²⁵

To take advantage of this change, Global Crossing laid a trans-Atlantic cable within ten months and embarked on ambitious plans to create a global fiber network. It reached \$1 billion in revenues within its first twenty months. Global Crossing continued to invest billions in creating the first network of fiber-optic cable across the world's oceans. Global Crossing's fall, however, was as swift as its rise. Competitors appeared. Internet traffic grew, but not at the rate expected. Moreover, technological innovation allowed much more information to be carried over the same cable. As a result, there was massive overcapacity in the industry. Global Crossing's revenue barely paid its ongoing expenses, and its stock price collapsed.¹²⁶

When times were good, J.P. Morgan made large loans to Global Crossing and also established lines of credit that Global Crossing could draw down provided it met specified revenue goals. As Global Crossing's financial condition deteriorated, its directors told J.P. Morgan that it had met its revenue goals and J.P. Morgan allowed it to draw down on the multi-billion dollar credit line.

After Global Crossing collapsed, J.P. Morgan discovered that Global Crossing had met the revenue numbers needed to draw on the credit line through a loophole in the credit agreement. The agreement allowed Global Crossing to count as current revenue money it would receive from other carriers who leased fiber-optic cable to it. Global Crossing entered into many such leases with carriers who, at the same time, leased fiber-optic cable back from Global Crossing. The payment obligations each owed the other netted out to zero, but the credit agreement did not require that Global Crossing's own payment obligations be offset against the payments it was receiving when it reported its revenue. As a result, Global Crossing could enter into leases of

124. JP Morgan Chase Bank v. Winnick, 350 F. Supp. 2d 393 (S.D.N.Y. 2004).

125. For an account of Global Crossing's rise, see GEORGE GILDER, *TELECOSM: HOW INFINITE BANDWIDTH WILL REVOLUTIONIZE OUR WORLD* 183-90 (2000).

126. Reinhardt Krause, *More Worries Surface About Global Crossing After Canceled Merger*, *INVESTOR'S BUS. DAILY*, Nov. 13, 2001, at A8.

cable that neither it nor the other party would ever use and the only consequence would be the illusion of revenue that did not in fact exist.

While Global Crossing disclosed that it entered into reciprocal trades, it did not disclose the extent to which the trades had been entered into solely for the purpose of creating the appearance of revenue. If J.P. Morgan knew just a little more about these reciprocal trades than it was told, it would not have allowed the draw on the credit line. Of course, if J.P. Morgan could show that the directors affirmatively lied to it and that it relied on these lies, it could prevail under an ordinary fraud action. But showing scienter on the part of the directors was hard, and J.P. Morgan would have a much easier row to hoe if Global Crossing and its directors had an affirmative duty to disclose.

If J.P. Morgan bought several billion dollars' worth in Global Crossing stock under similar circumstances instead of providing the same amount in the form of debt, it could sue the directors for failing to disclose the way the revenue numbers were generated. Just as the directors of a closely held firm who ask a shareholder for a cash infusion must disclose all of the relevant facts about its financial position or face personal liability for negligent misrepresentation, so too Global Crossing's directors would face liability if it were seeking an equity contribution from J.P. Morgan.

But given existing conceptions of fiduciary duty, there is no similar liability when directors seek an additional loan from an existing creditor. Because a corporation, by the conventional account, has no fiduciary relationship towards its creditors, the corporation and its directors have no obligation to disclose material, nonpublic information to them.¹²⁷ The District Court in *JP Morgan Chase Bank v. Winnick* rejected the argument that there were such disclosure obligations on just these grounds.¹²⁸

Of course, one could argue that a duty to creditors in fact existed. As we discussed in Part II, courts in Delaware have recognized that a duty to creditors does exist when the corporation is in the "zone of insolvency." One might argue that, given that Global Crossing was in the "zone of insolvency" at the time it drew on the credit line, it did in fact have a duty to disclose to J.P. Morgan. Even if J.P. Morgan has no right to bring a direct action against the directors for breach of duty, the duty may itself be sufficient to allow an action for failure to disclose.

But it does not make sense to go down a path that makes anything turn on fiduciary duties. One cannot sensibly allocate disclosure duties by sorting through different types of investors. The characteristics that delineate investor topology—mostly cash flow and voting rights—are, at best, weakly correlated with investor labels. A high-yield junk bond (creditor) and ordinary equity (shareholder) are similar to each other, not only with respect to the cashflow

127. Under Rule 10b-5, there is also the additional question of whether the bank loan counts as a "security."

128. See *Winnick*, 350 F. Supp. 2d at 401.

rights, but also with respect to control rights. The covenants on the typical junk bond give creditors enormous control over the board and the corporation, including control over matters shareholders themselves do not control, such as the hiring and firing of the CEO.

In addition, creditors often have close relationships that mimic those of shareholders who are owed fiduciary duties. As discussed above, firms generally owe strangers no duties (think of the farmers with oil under their land) while having to treat those close to them (think of ordinary shareholders) differently. But increasingly creditors look more like the latter than the former. Return to the example of J.P. Morgan and Global Crossing. In this case, J.P. Morgan was as far from being a stranger (such as a farmer who sells mineral rights to a mining company) as one can imagine. It is closer to the firm than the typical shareholder who buys on an exchange. It had invested billions in the business, had done extensive due diligence, and was already entitled to all the information that the corporation possessed. It is odd to find that a director has no more duty to disclose information to such an investor than to a complete stranger.

The question of what disclosure duties exist might more sensibly turn not on notions of fiduciary duty, but on the relative ability of the parties to contract or expand the disclosure obligation that the law otherwise puts in place. It might seem that opting out of (or into) a disclosure requirement would be easy for a sophisticated investor such as J.P. Morgan, and therefore that the law need not give it much. The law on this point, however, is not clear.

On its face, disclosure obligations under the securities laws cannot be waived at all.¹²⁹ Nevertheless, an essential element of an action (either at common law or under securities law) is the injured party's reliance on the nondisclosure. This has allowed a practice to emerge in specialized markets in which trading by those with material, nonpublic information is common and both parties want to opt out of any disclosure obligations the law imposes. They exchange what are called "Big Boy" letters. Each party asserts that it is a sophisticated investor (a "Big Boy"), recognizes that the other may possess material, nonpublic information, and affirms that it is not in any way relying on the other's failure to disclose that information. Whether Big Boy letters work remains to be seen,¹³⁰ but they should, at least if the one signing the Big Boy letter is a sophisticated investor like J.P. Morgan.¹³¹

129. Securities Exchange Act of 1934, 15 U.S.C. § 29(a) (2000).

130. Courts are split on whether these contracts are valid waivers of claims under the securities laws. *Compare* *Harsco Corp. v. Segui*, 91 F.3d 337, 341-48 (2d Cir. 1996) (upholding contract and dismissing claim), *and* *Jensen v. Kimble*, 1 F.3d 1073, 1074 (10th Cir. 1993) (same), *with* *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, 180 (3d Cir. 2003) (refusing to hold as a matter of law that nonreliance provisions are sufficient to immunize any Rule 10b-5 claims).

131. *See* Daniel M. Sullivan, Comment, *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533 (2008).

If Big Boy letters work and if disclosure duties cannot be easily created by contract (a subject to which we return below), then it becomes easy to argue in favor of strong background disclosure obligations, at least with respect to any transactions in which the relationship between the parties is as well established as the one between J.P. Morgan and Global Crossing. In a world where an investor is owed no duties of disclosure, an investor's ability to ensure that it receives the relevant information requires it to ask the right questions. This is by no means easy when the challenge is not gaining access to information, but rather in having access to so much that it is hard to sort and process. With respect to Global Crossing, J.P. Morgan had access to all the relevant information, but it lacked the ability to make sense of it.

Under these circumstances, it may make sense to have a menu of different disclosure obligations embedded in the law that investors (and anyone else contracting with the corporation) could invoke in their original contracts.¹³² In other words, J.P. Morgan should have had the option to include a clause in its original loan agreement that, at least with respect to disclosure obligations, directors have the same duties toward it that they would have vis-à-vis someone to whom the corporation owed a fiduciary duty (without at the same time generating the fiduciary duty itself). A sensible menu provides a discrete array of choices that courts can interpret over time. It may provide parties with more certainty than they could enjoy for a term they crafted themselves.¹³³ The law could provide other types of disclosure obligations, but the key is separating the disclosure obligation from the duty itself.

Such a "menu" of disclosure choices allows parties to write what is, in effect, an "anti-Big Boy" letter. In a Big Boy letter, sophisticated investors opt for the menu choice of "none of the above." In an anti-Big Boy letter, two sophisticated parties agree that, in circumstances where the law sees no duties, they will treat each other not like strangers, but like shareholders or others to whom disclosure obligations are owed. Of course, if it were as easy to write an anti-Big Boy letter that opts in to disclosure obligations as to write the standard one that opts out of them, providing a menu would not be necessary and the disclosure obligation the law provides as a baseline would be of little moment. But fashioning an anti-Big Boy letter may not be easy under current law.

Personal liability of the directors is an essential ingredient of any disclosure obligation in this context. Without it, the investor's only cause of

132. This idea that the law can play a useful role in providing menus for parties to draw upon was first developed by Robert Rasmussen. See Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992). In recent years, others have expanded on this insight. See, e.g., Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3 (2006); Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination* (Yale Law Sch. Working Paper No. 335, 2005).

133. As Michael Klausner has pointed out, providing a menu of choices in such circumstances may be a way to mitigate the network externalities problem that exists when each party is forced to craft its own terms. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 837-41 (1995).

action for the failure to disclose is against a party (the corporation) that already is liable on the underlying obligation. (J.P. Morgan already has a claim against Global Crossing for the amount of the loan. Being able to hold it liable for failure to disclose gives it nothing it does not already have.) But it is not at all clear that directors could be held personally liable in the event of a breach of an anti-Big Boy letter. Directors are not generally parties to a corporation's contracts, and they may not be liable under current law for breach by the firm of an anti-Big Boy letter.

One way around this difficulty would be to view the duties a firm adopts by contract as voluntary fiduciary duties. In the very few cases in which directors have been held personally liable or have personally paid settlements for corporate law failings, the allegations involved breaches of fiduciary duties.¹³⁴ In this way, a breach of the terms of the anti-Big Boy letter, such as a failure to disclose material, non-public information that a similarly situated shareholder would be entitled to receive, would amount to a breach of the board's (and therefore individual directors') fiduciary duties.

But courts might be reluctant under current law to impose duties that ordinarily arise only in a "special relationship" in circumstances where such a relationship does not exist. Other barriers to free contracting also exist. For instance, most firm charters contain statutorily authorized exculpatory provisions that eliminate director liability for breaches of fiduciary duty that are not disloyal.¹³⁵ It may seem simple enough to opt out of exculpatory by-laws, but this would require an expensive and uncertain shareholder vote, and might not even work, as the further the parties get from agreements that look like fiduciary duties,¹³⁶ the less likely courts will be to hold directors personally liable under a fiduciary duty-like doctrine.

Under existing law, the directors could, of course, co-sign for the loans, not in the sense of shouldering a repayment obligation in the event of a default, but agreeing, by contract, to be personally liable in the event of a failure to meet specified disclosure obligations. But executing a contract like this in a legal void would be extremely costly to implement. The directors would demand clarity about what they were required to do and when they would be liable. A standardized menu of options can provide more clarity, at least over time.

So where does this leave us? Linking disclosure solely to fiduciary duties,

134. See Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1068-70 (2006) (finding twelve cases of personally liability over the period between 1991 and 2004, all of which were for securities fraud or breaches of fiduciary duty).

135. See DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2008).

136. In general, trusts and fiduciary duties are not capable of modification by exculpatory provisions. See UNIF. TRUST CODE § 1008 (2005) ("(a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it: (1) relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or (2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor."); see also RESTATEMENT (SECOND) OF TRUSTS § 222(3) (1959) (same).

as is the case today, makes little sense. A modest reform might be for the law to get out of the way of Big Boy letters and anti-Big Boy letters by rejecting the rigid linkage between the obligations of directors to, and only to, fiduciaries and disclosure obligations. In all events, however, the law should stand largely in support of the contracts the parties write, and, where possible, make it easier (through menus and other devices) for parties to set out their obligations to each other. And, if one believes that free contracting over disclosure is relatively easy today (we don't), then instead of a convoluted fiduciary duty analysis, the court in *Global Crossing* should have based its decision on the ground that J.P. Morgan could have contracted for this information or these duties but did not.

CONCLUSION

In this Article, we have shown that the concept of directors' duties in corporate law has been too narrowly conceived and too constrained by outdated and over-simple notions of capital structure. But the problem is in fact much more pervasive than this. Conventional accounts of corporate law (whether in the law and economics literature or elsewhere) have, as a general matter, given far too much weight to the separateness of debt and equity, and have privileged equity and the rights of equityholders in corporate law in a way that is now completely out of step with modern finance.¹³⁷

Directors should take from court decisions the simple maxim that they should do what is in the best interest of the firm, measured from the perspective of the ex ante bargain among investors. This will mean maximizing firm value in nearly every case, but, as in *Orban*, sometimes acting in ways that are selfish and may not, ex post, always be value maximizing. Board decisions should follow control rights, wherever and in whatever form they are manifest, and courts should largely get out of the way. This means courts should refuse to give creditors fiduciary duties (say in the zone of insolvency), refuse to allow shareholders to use fiduciary duties as a mechanism for upsetting director decisions that increase firm value or are conceivably part of the investors' ex

137. For example, Lucian Bebchuk's academic project is primarily about increasing the power of *shareholders* vis-à-vis managers. Not only are "shareholders" becoming increasingly hard to define, but Bebchuk, like most others, largely leaves other investors out of the equation. A recent book-length treatment of the issue of shareholder activism is typical in its neglect of creditors. In *The Rise of Fiduciary Capitalism*, James Hawley and Andrew Williams praise the stakeholder model of corporate governance, noting that "stakeholder claims directly challenge the finance model's assertion that shareholders are the only . . . claimants on the firm's residual profits and those with ultimate control authority." JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM* 85 (2000). The authors go on to define their claim for stakeholder power: "For example, in its broadest form a stakeholder perspective takes what can be characterized as the 'social debt' of the corporation perspective." *Id.* The authors are not alone in largely ignoring creditors or "financial debt" and its role in the governance of firms.

ante bargain, and refuse to perpetuate the inefficient link between disclosure and fiduciary duties.

Written nearly a century ago, Louis Brandeis's *Other People's Money* criticized the way creditors exercised the power they had over firms. Brandeis showed that banks were significant investors in and exercised substantial control over the firms to which they lent.¹³⁸ Brandeis then went on to argue that banks ought to exercise this control with an eye toward the interests of the middle-class workers who provided the banks' capital.¹³⁹ Modern accounts of corporate governance have forgotten about Brandeis and the centrality of the creditor in the corporate enterprise. Following Berle and Means's *The Modern Corporation and Private Property*, they have focused instead on the diffusion of equity interests and the resulting separation of ownership and control.¹⁴⁰ Our Article is about resurrecting Brandeis's positive account—that banks and other creditors are central to any coherent account of corporate governance—while leaving aside his populist normative claim for others to take up. Corporate law has focused too long on shareholders as the sole investors in the corporation, the sole recipients of director duties and energies, and the sole hope for constraining the managers of other people's money.

138. See, e.g., BRANDEIS, *supra* note 4, at 36 (describing the “endless chain” of transactions that bankers in control of firms used to benefit themselves).

139. *Id.* at 135-36.

140. See ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

