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Article 1

THE ROLE AND LIMITS OF LEGAL REGULATION OF CONFLICTS
OF INTEREST (PART II)

Conflicts of Interest in Publicly-Traded and Closely-Held Corporations: A Comparative and Economic Analysis

Zohar Goshen*

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Conflicts of Interest in Publicly-Traded and Closely-Held Corporations: A Comparative and Economic Analysis

Zohar Goshen*

Conflicts of interest in corporate law can be addressed by two main alternatives: a requirement of a majority of the minority vote or the imposition of duties of loyalty and fairness. A comparison of Delaware, the UK, Canada, and Israel reveals that while the conflicts of interest problem within publicly-traded corporations receives different treatment in the different jurisdictions — either a fairness rule or a majority of the minority rule — closely-held corporations receive the same treatment of an imposition of duties of loyalty and fairness. This article explains this finding, demonstrating that determining which of these rules is adopted is, in fact, a choice between liability rule protection and property rule protection. This choice depends on the total and relative transaction costs. These costs include both the negotiation costs attendant upon a property rule, as well as the adjudication costs associated with a liability rule. The sum of these costs is influenced by the efficacy of the judicial system and of extra-legal mechanisms such as the market for corporate control, the capital market, and the types of investors active in the market. Because the different jurisdictions have different relative costs, due to differences in the economy and the legal systems, publicly-traded corporations

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are treated differently in each system. However, sometimes conflict of interest situations share the same main characteristics — as with closely-held corporations — leading to the domination of one solution, and thus the same solution is applied for closely-held corporations in the different jurisdictions.

INTRODUCTION

Conflicts of interest exist in a large variety of corporate transactions. Most notably, conflicts of interest exist in transactions between the corporation and a party that controls or manages the corporation or a transaction between the corporation and other entities that are related to the controlling or managing party.¹ When presented with conflicting interests, a shareholder (or other members of the corporation) is likely to gravitate towards the choice that provides her with the greatest chance of personal benefit. Such individualized assessment of a transaction's personal value (as opposed to its value to the corporation as a whole) lies at the root of the conflicts of interest problem.²

Legal systems address similar conflicts of interest problems in a variety of ways. In Delaware, for instance, transactions involving a conflict of interest for a controlling shareholder, a director, or officer are subject to the "entire fairness" test: the party interested in the transaction's performance must demonstrate that the transaction is the product of "fair dealing" and reflects a "fair price."³ Indeed, the fairness test is the dominant tool for adjudicating conflicts of interest in the overwhelming majority of US jurisdictions, and it applies to publicly-traded corporations as well as closely-held corporations.⁴

Still, the fairness test is by no means a universal solution to the problem

1 See, e.g., Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997); Kahn v. Lynch Communication Sys., 638 A.2d 1110 (Del. 1994); Wiegand v. Berry Petroleum Co., 1991 Del. Ch. Lexis 37; Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985); Cookies Food Prod. v. Lakes Warehouse, 430 N.W.2d 447 (Iowa 1988); Levien v. Sinclair Oil Corp., 261 A.2d 911 (Del. Ch. 1969); David J. Greene & Co. v. Dunhill Int'l Inc., 249 A.2d 427 (Del. Ch. 1968); Warshaw v. Calhoun, 221 A.2d 487 (Del. 1966); Ripley v. Int'l Rys. of Cent. Am., 8 N.Y.2d 430, 209 N.Y.S.2d 289 (1960); Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57 (Del. 1952).

2 The conflict of interest problem is only one manifestation of the fundamental "agency problem" pervading corporate law. See M.C. Jensen & W.H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

3 See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

4 See Principles of Corporate Governance §§ 1.09, 1.20, 5.02, 5.07 (1994); Cal. Corp.

posed by conflicting interests in the corporate setting. In Canada, for example, certain transactions involving conflicts of interest of a controlling shareholder, a director, or officer, in publicly-traded corporations may be performed only with the approval of the disinterested shareholders ("a majority of the minority").⁵ This is the case in the United Kingdom as well.⁶ Similarly, in Israel, certain conflicted transactions in publicly-traded corporations require, in addition to achieving majority, the support of at least a third of the disinterested shareholders.⁷ However, in Canada, the United Kingdom, and Israel, conflict of interest transactions involving closely-held corporations are not subject to the majority of the minority rule, but to some variation of a fairness test stemming out of a duty of loyalty.

Why do we see different solutions among the different jurisdictions regarding publicly-traded corporations, while an identical solution is adopted regarding closely-held corporations? What are the economic implications of the differing approaches? What factors will determine which approach is adopted?

The primary aim of this article is to explore these questions by employing the well-known distinction between property rules and liability rules.⁸ This distinction, usually employed to classify individuals' rights, will be used here to classify groups' rights. The solutions to the conflict of interest problem in the corporate context can be seen as providing the disinterested party (e.g., the minority) with the protection of either a property rule or a liability rule.⁹

A property rule prevents any transaction from proceeding without the

Code § 310 (West 1999); Del. Code Ann. tit. 8, § 144 (1998); N.Y. Bus. Corp. Law § 713 (McKinney 2001); Model Bus. Corp. Act § 8.31 (1984).

5 See Ronald J. Daniels & Jeffrey G. Macintosh, *Toward a Distinctive Canadian Corporate Law*, 29 Osgoode Hall L.J. 863, 929 (1991).

6 See London Stock Exchange Listing Rules ch. 11 (2001), available at <http://www.fsa.gov.uk/pubs/ukla/chapt11-2.pdf> [hereinafter LSE Listing Rules]. Sections 11.4(c) and (d) provide that in a transaction with a "related party", defined in section 11.1(c) to include a greater than 10% shareholder, the company must,

(c) obtain the approval of its shareholders either prior to the transaction being entered into or, if it is expressed to be conditional on such approval, prior to completion of the transaction; and (d) where applicable, ensure that the related party itself abstains, and takes all reasonable steps to ensure that its associates abstain, from voting on the relevant resolution.

7 Companies Act, 1999, § 275, S.H. 189.

8 See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972).

9 Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Cal. L. Rev. 393 (2003).

minority owner's consent. In general, a property-type protection establishes a system in which both transaction performance and price demand are determined on a purely consensual basis. That is, a transaction is only performed with the consent of the disinterested group, at a price that is a function of the group's subjective evaluation of its worth. This category may include systems that either deny interested parties a vote in the matter or require the approval of the disinterested "majority of the minority" before the transaction may proceed.

A liability rule allows transactions to be imposed on an unwilling minority, but ensures that the minority is adequately compensated in objective market-value terms. This category includes systems that allow a controlling owner with a conflict of interest to execute the transaction, but require that the transaction be "fair."

Characterizing the solutions to the conflict of interest problem as either property rule protection or liability rule protection, this article examines the parameters influencing the choice between them. Indeed, the choice between the rules is affected by transaction costs: adjudication and negotiation costs. This article reveals the factors influencing the transaction costs in the corporate context and explains the variety of the solutions: why in some conflict of interest transactions different legal systems choose different solutions, while in other conflicted transactions they choose the same solution.

Part I of the article describes the problem of conflicts of interest and the possible solutions to the conflict of interest problem. In Part II, the different approaches to resolving the problems raised by conflicting interests are discussed in terms of liability/property rules. Part III describes the different factors affecting the choice of an optimal solution and illustrates the implications of the analysis to the regulation of conflicted transactions of publicly-traded corporations and closely-held corporations.

I. CONFLICTS OF INTEREST AND POSSIBLE SOLUTIONS

The conflict of interest problem is quite common in situations where a transaction is slated between a group and one of its members — for instance, a controlling shareholder transacting with the controlled corporation. In such circumstances, there is a risk that the transaction will not reflect market terms, thereby benefiting the controlling shareholder at the expense of minority shareholders. As the controlling shareholder vote on such a transaction is tainted, a conflict of interest situation neutralizes the normal

voting mechanism's ability to determine group preference.¹⁰ For this reason, evaluating whether a transaction is beneficial for the shareholders as a group must be approached differently when such conflicting interests exist.

Indeed, it does not necessarily follow that all transactions bearing an element of conflicting interests are inefficient transactions. It is possible that, in certain situations, a transaction with an interested shareholder may be the best option available to the group. For example, a corporation seeking credit may turn to one of its controlling owners to make a loan to the corporation. Indeed, in some cases, an important transaction may simply be impossible without such self-dealing.¹¹ Similarly, a self-dealer may have a competitive edge in the market or even an advantage stemming from her proximity to the group, which ensures that a deal with her is in the group's best interests.

The question of whether transactions involving conflicting interests are efficient or inefficient lies at the root of the conflict of interest problem. It requires a system that can distinguish between the good and bad deals. As part of any solution to the problem of conflicts of interest, the goal must be to maximize the execution of efficient deals and to minimize the execution of inefficient ones. Corporate law has addressed this problem with a variety of solutions. The main solutions are the majority of the minority rule and the fairness test.

A. The Majority of the Minority Vote

Under this solution, the vote of the self-dealer is not taken into account.¹² Only those members of the group with no ulterior interests are relevant if the vote is to express the group preference. The ban on conflict of interest voting will prevent a self-dealer from imposing a transaction on an unwilling minority. Moreover, since such an approach is based upon the minority's consent, it is unnecessary to evaluate the quality of the transaction. It will be reasonable to assume that the vote does, in fact, reflect the group preference. This solution has many variations. Usually, a simple majority of the minority is required, while in some cases a supermajority vote is demanded.

10 Kenneth J. Arrow, *Social Choice and Individual Values* (2d ed. 1963); Duncan Black, *The Theory of Committees and Elections* (1958).

11 *See, e.g.*, *Case v. New York Cent. R.R.*, 204 N.E.2d 643 (N.Y. 1965) (consolidation of taxes between the parent corporation, which suffered losses, and its subsidiary, which registered profits, created a tax saving).

12 *See, e.g.*, LSE Listing Rules, *supra* note 6.

B. The Fairness Test

In this solution the self-dealer is permitted to vote, but the transaction is subjected to a fairness test.¹³ A solution that examines a transaction against the fairness standard in effect allows the person with a conflict of interest to effect a "taking," i.e., to impose the transaction on the minority, but it likewise enables the minority to claim before the courts that the transaction is unfair.¹⁴ The use of an objective measuring standard leaves no place for unique characteristics or special assessments of value that might affect the value the parties themselves actually ascribe to the assets.¹⁵

II. CHARACTERISTICS OF THE SOLUTIONS

Although the conflict of interest problem in corporate law usually involves groups, the variety of the solutions can be analyzed using the well-known classification of individuals' rights into property rules and liability rules.¹⁶

A. Property Rules versus Liability Rules

A property rule precludes the carrying out of any transaction to which the owner has not consented.¹⁷ A liability rule is a legal rule that allows a transaction to be forced upon a party, provided that objectively fair compensation is made.¹⁸

The majority of the minority rule may be best understood as a property rule protection, and the fairness test should be understood as exhibiting a liability rule approach. As shown below, this categorization is based on both the type of valuation that characterizes each rule and the ramifications of its distributive effect. However, the ultimate characterization of a rule as

13 See, e.g., *Lewis v. S.L. & E., Inc.*, 629 F.2d 764 (2d Cir. 1980); see also cases cited *supra* note 1.

14 The duty of loyalty has a similar effect. See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947). By imposing a duty of loyalty, the law requires the majority to exercise its discretion in good faith for the benefit of the group as a whole. Determining whether the duty was violated in a conflict of interest deal will require an objective evaluation of the deal.

15 See, e.g., Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. Legal Stud. 165 (1988).

16 See Calabresi & Melamed, *supra* note 8.

17 See *id.* at 1092.

18 See *id.*

either a liability or property rule is dependent on the remedies provided by the courts when the rule is violated. In this respect, two issues are critical: access to courts and the type of enforcement.

1. Access to Courts

Once a rule is violated, the first step in obtaining a remedy is the ability to access the court. Mechanisms such as derivative suits or class actions with appropriate incentives to use them must exist in order to facilitate access to courts. A rule "on the books" without any possibility of accessing the court in order to enforce the rule is useless.¹⁹ However, access can be provided in different degrees. One legal system may allow any shareholder to bring a derivative suit, while other systems may restrict this right to shareholders holding 5% of the shares or 10% of the shares or restrict this right altogether. Similarly, access to courts may be denied indirectly by curtailing incentives and imposing high risks and costs on those attempting to bring suit.

2. Type of Enforcement

Once a rule is on the books and access to the court is obtained, the crucial element is the type of enforcement provided. A system could have property rule protection on the books but liability rule protection in practice, and vice versa. Assume that the law of a particular country requires majority-of-the-minority approval for a conflict of interest transaction. This suggests that this country has adopted property rule protection. Now assume that the interested majority shareholder does not refrain from voting and accordingly causes the corporation to approve the conflict of interest transaction. If a court facing a claim based on this transaction does not invalidate the deal but instead looks only to its fairness, then it becomes evident that the law of that country is better characterized as a liability rule rather than a property rule.²⁰

Whether the law as stated on the books is, in effect, the real approach of the law in any given jurisdiction depends on the quality of the courts and judges in interpreting and effectively implementing the law as it is stated. If courts and judges refuse or are unable to enforce the law as it is

19 Indeed, there are countries in which the legal rights are not coupled with effective access to courts. See Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997).

20 This is the case in Italy, see Luca Enriques, *Off the Books, But on the Record: Evidence from Italy on the Relevance of Judges to the Quality of Corporate Law*, in *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* 257 (Curtis J. Miluaupt ed., 2003).

stated in the statutes, then it is obvious that the law will be different from that envisioned by the legislators.²¹ In sum, the crucial factors in determining whether a particular rule is a property rule or liability rule are access to courts and the type of enforcement available. While access to courts is primarily controlled by the quality of the law, the type of enforcement is primarily controlled by the quality of the judiciary. In the following analysis, I assume a proper characterization of the rules.

B. Subjective versus Objective Valuations

The two solutions — the fairness test and the majority of the minority rule — may be distinguished by the manner in which the parties value a transaction. A solution based on the majority of the minority rule grants to the minority the power to determine whether or not a transaction will be approved, and the majority is unable to force a deal upon the minority. Thus, a transaction will only transpire if the majority of the minority has consented to it. This arrangement empowers the minority to look after its own interests and to strive to obtain the maximum price it can achieve. Consequently, such a solution should be viewed as a property rule, since placing the decision in the minority's hands simply maintains a regime of voluntary transactions and preserves the role of subjective valuations.

A solution based on the fairness test assumes that, once conflict of interest voting is permitted, the majority can force a transaction upon the minority. The protection afforded to the minority ensures only that a fair price is obtained, which is determined by evaluating the objective value of the transaction. Thus, such a solution should be viewed as a liability rule, as it establishes a regime of involuntary transactions and, thus, replaces subjective valuations of the contending groups of shareholders with an objective measure.

C. The Division of the Surplus

A voluntary transaction between individuals generates a surplus, as a result of the difference in the subjective values the parties attach to the deal. The difference between the valuations of a buyer and a seller represents the surplus from the transaction. That is, if *A* values an asset at \$100, while the same asset is worth \$200 to *B*, the \$100 difference in their valuations will constitute surplus. Any actual price that the parties might strike between

²¹ *See id.*

\$100 and \$200 will thus be an efficient transaction. When an asset has no market price, the division of the surplus will be subject to negotiation and the outcome will depend upon external factors, such as the negotiating skills and bargaining power of each party.²² If the price is set at \$101, *A* receives \$1 and *B* \$99 of the surplus, whereas if the price is \$199, the division of the \$100 of surplus will be reversed between *A* and *B*. In either instance, the transaction will be an efficient transaction and will be "fair" in the sense that it will be effected with mutual consent and, as such, will be upheld by the courts.

When the asset is protected by a property rule, the buyer has no means of compelling its purchase. The seller can negotiate freely in an attempt to secure a larger share of the surplus. Her success in seeing the deal performed will depend on her negotiating skills and whether alternatives exist that may substitute for the asset. Conversely, where the asset is protected by a liability rule, the purchaser need not enter negotiations at all; she can simply take the asset by offering a price that is objectively fair. What is a "fair" price? If the court's test is based on the price set between a willing seller and a willing buyer, then a fair price will be any price between \$101 and \$199.²³ Accordingly, it may be assumed that the purchaser will offer a price closer to \$101 than to \$199 because under a liability rule, the purchaser will endeavor to set a price by which most of the surplus will vest with him. The two solutions to the conflict of interest problem will have different effects on the division of surplus between the parties in the corporate context. The liability rule approach will give an advantage to the majority, whereas the property rule approach gives the minority greater negotiation power.²⁴

A liability rule is not predicated on negotiations and thus gives the majority the upper hand. Suppose that a group of voting shareholders has an asset that it values at \$100 and the majority group is interested in purchasing the asset, since it values the asset at \$200. In a regime built on the fairness test, the majority can force the transaction upon the minority, contingent upon its obligation to ensure a fair price. That is, the majority can offer a price in the lower range of possible surplus values, such as \$101, and still live up to the fairness standard. As long as the actual price falls between \$100 and

22 See, e.g., Robert Cooter, *The Cost of Coase*, 11 J. Legal Stud. 1 (1982).

23 See, e.g., Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 1988 J. Corp. L. 997.

24 See Susan Rose-Ackerman, *I'd Rather Be Liable Than You: A Note on Property Rules and Liability Rules*, 6 Int'l Rev. L. & Econ. 225 (1986); David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701, 707 (1987).

\$200, the minority will have sustained no actionable wrong.²⁵ The mere fact that the surplus has been divided inequitably does not demonstrate per se that the transaction is unfair.²⁶ However, the fairness test reliance on courts creates the risk that courts might erroneously ratify inefficient transactions or ban the efficient ones. To illustrate, in the above example, an inefficient transaction would occur if the majority proposed a price of \$95 and the courts approved the deal, overriding the minority's objections, based on a (faulty) objective assessment of the price.

The fairness test, however, does not guarantee the minority a large portion of the surplus, but it does encourage efficient transactions to be carried out. The majority will not be deterred by holding out and can push through any transaction it wishes, provided always that the minority will receive a fair price. Consequently, the fairness test reduces the profit on each transaction, but ensures the maximum number of transactions.

Property rule protection, on the other hand, requires the minority's approval for a transaction in which a conflict of interest arises, thereby empowering the minority to demand a larger portion of the surplus (for example, \$199) than it would receive under the liability rule. Yet, abusive holdout by the minority may also lead to the loss of worthwhile transactions. Thus, in the above example, let us assume that the majority offers a price of \$180 and the minority demands \$201. Although seemingly an irrational demand, this is possible since, in actuality, the minority has no way of knowing precisely what value the asset has for the majority and may mistakenly demand too much. The majority will not proceed with the transaction and the minority will remain with an asset worth \$100 (by its own assessment) instead of the \$180 that it might have received. An efficient transaction will thus be foiled.

Furthermore, the majority will know beforehand that the minority can extort a higher price and that, in any transaction it will propose, the minority

25 See, e.g., Revised Model Bus. Corp. Act § 8.61 note on fair transactions (1989) ("It has long been settled that a 'fair' price is any price in that broad range which an unrelated party might have been willing to pay or willing to accept, as the case may be, for the property, following a normal arm's-length business negotiation, in the light of knowledge that would have been reasonably acquired in the course of such negotiations, any result within that range being 'fair'...").

26 The most obvious example is the rule that in a merger, the "appraisal right" given to the shareholders does not include the profits from the merger itself. In other words, the opposing minority is given no portion of the surplus. See Benjamin E. Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. Legal Stud. 351 (1996).

will be unwilling to relinquish a sizeable portion of the surplus.²⁷ Therefore, the majority will refrain from initiating transactions with the minority and will seek out less extortive alternatives. Only when the minority possesses a unique asset will the majority be forced to address the minority's excessive demands, and even in such circumstances, some such transactions will fail to take place because of hold-out attempts. Consequently, the majority of the minority rule enhances the minority's ability to demand a larger share of the surplus in those transactions that are performed, but reduces the total number of transactions involving the minority that will in fact be performed.

III. FACTORS DETERMINING THE RIGHT SOLUTION

According to Coase's theorem, in a world without transaction costs, it makes no difference which rule is adopted: in either case efficient transactions will be performed.²⁸ The chosen rule will affect the division of surplus among the parties involved, but not the performance of the transaction. Where transaction costs are incurred, the choice between a liability rule and a property rule depends upon which legal rule better ensures the realization of efficient transactions and the avoidance of inefficient ones. Negotiation costs and adjudication costs are the transaction costs primarily responsible for the failure to bring about efficient transactions. Although negotiation costs and adjudication costs are both heavily dependent on the quality of the legal system and the presence of sophisticated investors, each rule has a different blend of negotiation and adjudication costs. The relative efficiency of each rule will depend on the total transaction costs each of them entails. Hence, the effect of the rules in any specific conflict of interest situation must be tested by focusing on all the costs involved in the transaction.

The first element of importance in measuring the relative costs is the *scale of the problem* as it is reflected in the *frequency* (the number of occurrences) and *quality* (the division between bad and good) of transactions involving self-dealing. The initial size of the problem is determined by the overall frequency of transactions involving self-dealing, as this number will determine the population of cases that should be screened by the legal regime. In markets where concentrated ownership and cross-holdings of corporations are widespread, the frequency of self-dealing is expected to be higher. Since the majority of the minority rule applies to *all screened*

²⁷ See *id.*

²⁸ See Ronald Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960).

transactions,²⁹ while the fairness test applies only to *challenged* transactions,³⁰ different frequencies will result in different transaction costs.

Similarly, the quality of the transactions will affect the *expected damage* of each screening device, as neither rule is perfect. Indeed, in a market in which 90% of the conflict of interest transactions are good while only 10% are bad, the respective effects of the two alternative rules will be different than if the situation were reversed. The majority of the minority rule is likely to prevent most of the bad transactions, but it will also lead to the rejection of some good transactions as a result of strategic behavior. The fairness test is likely to facilitate most of the good transactions, but it will also lead to the approval of some bad transactions as a result of the inefficiencies and errors endemic to the legal system. Thus, different qualities of self-dealing will result in different transaction costs.

However, the rule itself and the quality of its enforcement, in turn, will affect the initial frequency and quality of conflict of interest transactions, as each rule has different effects on the incentive to engage in self-dealing. For instance, a majority of the minority rule entails the costs of securing minority support with low probability of success when expropriation is contemplated. This should deter some transactions, bad and good, and thus will decrease the frequency of conflict of interest transactions and increase their quality. Similarly, if under a fairness test, the probability of securing court approval for expropriation is high, the frequency of conflict of interest transactions will increase and the quality will decrease.

Beyond the rule itself, other factors influence the scale of the problem and, consequently, the relative costs of the different rules. One such factor is the market for corporate control. The market for corporate control challenges inefficiency both by imposing a potential threat of a takeover as a deterrent to poor management and by means of the steps taken once a takeover has actually been executed.³¹ The most important factor determining the existence of a market for corporate control is whether shareholding is dispersed or concentrated. Whereas dispersed ownership allows hostile takeovers to take place, concentrated ownership can render the corporation immune to takeovers. It makes no difference how inefficient the controlling

29 Different systems limit the number of screened cases by the size of the transaction or the size of the shareholdings of the person with a conflict of interest.

30 Some systems limit the number of challenged cases by requiring a certain minimum shareholding to bring a derivative suit.

31 See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965).

party is; so long as it holds an absolute majority, the controlling interest cannot be usurped other than through a consensual private transaction.

The effectiveness of the market for corporate control will affect the relative costs of the rules. Under a liability rule regime, an effective market for corporate control will result in fewer cases of exploitation and the scale of the problem will decrease. An ineffective market for corporate control, however, will not prevent exploitation, leaving the minority to rely mainly on the legal system. Consequently, the efficiency and effectiveness of the judicial system will determine the ultimate scale of the problem.

Similarly, under a property rule regime, an effective market for corporate control will reduce the scale of the problem. Theoretically, under a property rule, the minority can protect its own interest more effectively than would the indirect threat of a takeover. In practice, however, the ability of the minority to protect itself depends on the sophistication of the investors comprising the minority and the effectiveness of the court in enforcing the property rule. With effective enforcement of a property rule and the presence of dominant sophisticated investors, exploitation of the minority is difficult. Consequently, control will have little value to an entity interested in profiting at the minority's expense, as well as to a potential acquirer aiming to remove a party acting to the minority's detriment. In the absence of both effective enforcement and sophisticated investors, however, an effective market for corporate control will decrease the scale of the problem.

Indeed, the presence of sophisticated investors is a substantial factor affecting the relative costs of the different rules. Clearly, as will be shown below, the direct effect of sophisticated investors is on negotiation costs within a property rule and negotiation costs "in the shadow" of a liability rule.

However, sophisticated investors have additional indirect effects. When the minority is dominated by sophisticated investors, the market will operate efficiently. Sophisticated investors invest in the collection and evaluation of information and act in accordance with their findings on a consistent and professional level. Such investors are capable of pricing securities so as to incorporate the risk of self-dealing.³² In an efficient market, corporations seeking to raise capital to finance their business activities will have to pass the scrutiny of underwriters, investment banks, and other professionals who broker between corporations and potential investors. Efficient corporations will manage to raise capital on favorable terms, whereas

³² See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investors Voice*, 39 UCLA L. Rev. 811 (1992).

inefficient corporations will find capital available to them only on expensive terms, if at all. Corporations in which the majority exploits the minority will have difficulty raising additional capital; under such circumstances, it is obvious that investors will be unwilling to enter the corporation as part of the minority. By contrast, corporations structured so as to protect the minority will raise capital more easily and cheaply. Indeed, efficient capital markets provide some protection to the minority,³³ thereby reducing the prevalence of inefficient conflicted transactions.

Furthermore, sophisticated investors are active in the market on a long-term basis, behave consistently, and can thus properly appreciate a good reputation and punish a bad one. Indeed, sometimes social sanctions play a role in preventing abuse of the minority. The role of reputation in the business community is a non-legal factor that serves to reduce the risk to minority shareholders. A controlling owner who is interested in receiving public approval and maintaining a positive image as an honest dealer will refrain from abusing the rights of the minority even when no economic or legal sanction is threatened. The presence of sophisticated investors is an important ingredient supporting the breeding of positive social norms. Consequently, in a business community in which reputation plays a significant role, harmful self-dealing transactions might be avoided, thereby reducing the scale of the problem.³⁴ With this background, we can now turn to an analysis of the relative costs of the two rules.

A. Transaction Costs of the Majority of the Minority Rule

1. Adjudication Costs

The majority of the minority rule predicates the performance of a transaction on the ability to secure the consent of the disinterested members of the group. This consent, of course, will reflect a range of subjective assessments on the part of the voters. Generally speaking, court intervention to evaluate the fairness of the transaction will be unnecessary, since the transaction will

33 Yet the effectiveness of the capital market protection — efficient as it may be — is limited. In practice, public corporations in the United States often fund their activities through undistributed profits, rather than by raising capital from the public, thereby avoiding the disciplining effect of the market. In any case, when corporations subject themselves to the constraints of the capital market, they are, in fact, signaling their commitment to protect minority shareholders.

34 See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 *UCLA L. Rev.* 1009 (1997); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 *J. Pol. Econ.* 288 (1980).

take place under market conditions. The voting process itself, however, is susceptible to many possible distortions. For example, voters may be provided with misleading or insufficient information; managers or controlling owners may hold proxies from disinterested voters; certain voters may be promised benefits and thus are no longer "disinterested"; intimidation of voters with threats of retaliatory behavior may take place; or there may be hidden or unknown business or personal ties between voters and management or between voters and the controlling owner.³⁵

The risk of a flawed ballot will obligate the court to evaluate whether proper procedure has been maintained and that those voting were, in fact, disinterested. As compared to evaluating the transaction's merits, the court's role is relatively uncomplicated. The courts should have no difficulty in checking the procedures followed and the information that was supplied to the voters. At the same time, while it is difficult to determine whether a given voter is indeed disinterested, the determination will not entail high costs, since the courts are practiced in contending with issues of deceit. In addition, the probability of a large number of irregularities taking place in the voting process is small. Since large numbers of shareholders will participate in the vote, the chances of irregularities being discovered are high. Consequently, a property rule should involve low adjudication costs.

Indeed, it should be emphasized that the ability of courts to enforce a property rule in some predictable and consistent manner is the *minimum* level of efficiency and effectiveness required of any judicial system. Otherwise, high adjudication costs in enforcing a property rule (inefficient and corrupt courts) are tantamount to a system of no-protection, coupled with an inability to contract around the absence of a minority protection.³⁶

2. *Negotiation Costs*

A property rule represents a "negotiation" between the majority and the minority.³⁷ Negotiations involve several types of costs. The first is

35 See, e.g., *Citron v. E.I. du Pont de Nemours & Co.*, 584 A.2d 490, 520 (Del. Ch. 1990).

36 Indeed, there are countries in which the system of legal enforcement is so weak that the mere existence of minority shareholders' right to vote does not provide the shareholders with any meaningful protection due to the inability to enforce their rights. See *La Porta et al.*, *supra* note 19. Thus, this kind of "protection" should be regarded more like a no-protection regime rather than a property rule.

37 Indeed, the application of the liability rule/property rule distinction to cases of individuals' rights and a group's rights differs greatly. An important difference should be noted: while a property rule concerning individuals' rights allows for direct and normal negotiations, negotiations with the minority do not take a similar form.

administrative costs: dispatching notices that inform of an impending ballot and provide appropriate background information on the transaction to all voting shareholders, with each voter returning a proxy form indicating her vote. These costs certainly do not prevent negotiations from taking place, and indeed, for shareholders they are routine practice.³⁸

Second, the voting process requires that the voters study the material, develop a position, and vote. This can be expensive for the voters, and often many will refrain from voting or will blindly support management's position. The absence of part of the voting public will detract from the quality of the decision-making process. Moreover, a minority's blind support of management — generally the interested party — will thwart the purpose of having the matter put to the disinterested minority. However, where sophisticated investors are involved in the management of a corporation, the participation of informed and able investors in the decision-making process can improve the quality of decision-making.

Third, the voting process will also be susceptible to strategic voting. Some of the voters can adopt a hold-out strategy and turn down an efficient transaction in order to raise the price of their consent. The proponent of the deal himself can adopt a strategy of signaling by refusing to bow to extortion, striving to earn the reputation of a staunch negotiator, and prevent future hold-out attempts. If the minority consists of a very large group of voters among whom coordination is impractical, then a hold-out strategy will not be pursued. If the minority is made up of a few individuals or institutions who might easily join together, then hold-out will again be a significant risk. However, where sophisticated investors are present, the risk of disruptive hold-out is reduced. Although sophisticated investors can form

Voting is a more complicated form of negotiations. Sometimes it involves voting on a "take-it-or-leave-it" offer. Sometimes it involves informal discussions between some institutional shareholders and the corporation before an offer is put to a vote. And sometimes preliminary negotiations take place through a committee of the board of directors appointed for this purpose. In any case, the important feature is that in the end nothing compels a voter to accept an offer she deems inappropriate.

38 This description is not true in every country. There are countries in which the corporate law substantially increases the administrative costs. *See* La Porta et al., *supra* note 19 ("In some countries, shareholders must show up in person, or send an authorized representative, to shareholders' meeting to be able to vote In Japan, for example, about 80 percent of corporations hold their annual meeting on the same week, and voting by mail is not allowed ... in some countries, law requires that shareholders deposit their shares with the corporation or financial intermediary several days prior to a shareholder meeting This practice prevents shareholders from selling their shares for several days around the time of the meeting").

coalitions and hold-out, they will not demand an extortionist price that will cause the transaction to fall through, since they are able to correctly assess the profit to be gained by closing the deal.

The amount of these costs will be affected, in turn, by the prevalence of self-dealing that will trigger the need for shareholder votes. Negotiation costs will rise with the frequency of self-dealing transactions. Markets that are characterized by cross-ownership, concentrated ownership, and centralized economy can be expected to have more self-dealing transactions. Consequently, higher negotiation costs should be expected.

B. Transaction Costs of the Fairness Test

1. Negotiation Costs

A liability rule validates a self-dealing transaction on an objective, non-consensual basis and, as such, does not require negotiation. However, the parties can negotiate "in the shadow" of the liability rule to avoid legal intervention.³⁹ Negotiations in the shadow of the rule enjoy the benefits and costs of being informal. The costs of these negotiations will depend on the presence of sophisticated investors and the effectiveness of the judicial system. The more effective and precise the courts, the easier it is for sophisticated investors to anticipate judicial rulings and avoid the need for actual recourse to courts. The cost of these negotiations and the degree to which litigation can be avoided will depend on the specific characteristics of a given jurisdiction.

2. Adjudication Costs

A liability rule rests upon protection that requires routine intervention by the courts. The courts will be called upon as a matter of course to rule whether a given self-dealing is (objectively) fair. This does not mean that all transactions where a conflict of interest arises will entail litigation, since in many cases the minority will consider the proposed transaction to be fair, while in other cases, negotiation will yield a settlement. But those cases that do reach the courts will necessitate an examination of the merits of the deal, in a process for which adjudication costs will be considerable. It will be necessary to elicit professional opinions as to the value of the transaction, and the court will be compelled to decide between the inevitably differing opinions that will be tendered in order to find the "correct" value of the transaction.⁴⁰

³⁹ See Ian Ayres & Erie Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 *Yale L.J.* 1027 (1995).

⁴⁰ See, e.g., *Kahn v. Household Acquisition Corp.*, 591 A.2d 166, 175 (Del. 1991). In

Determining the objective value of a transaction is a complicated process requiring a high degree of competence from the courts (much higher than the minimum level required to enforce a property rule), since such valuations involve future projections of different variables (interest rates, cash flows, etc.), and the use of complex financial models.⁴¹ A liability rule based on judicial rulings, therefore, relies on the existence of professional institutions capable of providing worthy assessments, as well as competent courts possessing the necessary level of expertise to rule effectively in such areas. The professional standards of these institutions and the courts will obviously determine the direct adjudication costs.

However, the efficiency of the adjudication process will also influence the indirect adjudication costs. Indirect adjudication costs will depend on the frequency of wrong decisions in a given system. Any deviation from economic efficiency — the approval of an unfair transaction or the rejection of a fair one — means increased costs. The use of objective standards simplifies the task of evaluations since it is easier to place an objective value on an asset than to find a subjective value. It is important to remember, however, that where no market price exists, an "objective" value will be the product of subjective assessments, so that the risk of mistakes is not eliminated. Every mistaken decision harms the welfare of society as a whole. The number of faulty decisions will be reduced if professional institutions are more trustworthy and impartial and the courts more competent. When, on the other hand, the professional institutions cannot be relied upon or slant their opinions to the benefit of those soliciting them or when the courts are incompetent, overburdened, or corrupt, the number of wrong decisions will be much larger and their attendant costs much more significant.

High indirect adjudication costs may inflict a severe blow to economic efficiency. First, they will affect the willingness of investors to invest in corporations as minority shareholders. Second, they will frustrate effective negotiations in the shadow of the rule. Third, they will impose unnecessary costs on the majority to create reliable and cost-effective alternative defenses to secure potential investors.

In re Shell Oil Co., 607 A.2d 1213, 1222 (Del. 1992), the Delaware Supreme Court recognized the difficulties raised by the battle of experts in appraisal proceedings and recommended that the Chancellor appoint its own expert witness.

⁴¹ See *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983) (all commonly accepted evaluation methods must be taken into account).

C. Implications of the Analysis

A brief empirical survey of the protections provided to minority shareholders in a number of jurisdictions confirms the above analysis and reveals some data as to the weight that the outlined factors have on the choice of the rule to apply in each system.

1. Publicly-Traded Corporations

In a comparison of Delaware, the United Kingdom, Canada, and Israel, it can be seen that conflict of interest in publicly-traded corporations are treated differently. Delaware has adopted a liability rule to govern self-dealing.⁴² The United Kingdom and Canada have both adopted a liability rule in their corporate laws,⁴³ but publicly-traded corporations have to follow a property rule mandated by the stock exchanges.⁴⁴ Finally, Israel has adopted property rule protection to govern publicly-traded corporations, coupled with a liability rule.⁴⁵ What accounts for these different solutions? An analysis of the differing legal and economic conditions in these jurisdictions reveals different levels of transaction costs for each rule in each system.

An evaluation of the various characteristics of the American market supports the adoption of a liability rule in Delaware. Delaware courts are unique in their expertise in appraising values and in their mastery of corporate law in general and in handing down decisions with the efficiency, reliability, and speed crucial to a dynamic business world. Shareholding is widely spread among diverse investors in the U.S., so that a market for corporate control is possible.⁴⁶ The capital market is fairly efficient;⁴⁷ a large segment of minority shares are held by sophisticated institutional investors;⁴⁸ and the

⁴² *See id.*

⁴³ For the UK, see Paul L. Davies, *Gower's Principles of Modern Company Law* 707 (6th ed. 1997). For Canada, see Bruce L. Welling, *Corporate Law in Canada, The Governing Principles* 553 (2d ed. 1991).

⁴⁴ For the UK, see *supra* note 6. For Canada, see Policy Statement 9.1 — Disclosure, Valuation, Review and Approval Requirements and Recommendations for Insiders Bids, Issuer Bids, Going Private Transactions and Related Party Transactions (July 5, 1991), as revised in Revisions to Commission Policy Statement 9.1 (June 26, 1992).

⁴⁵ *See* Companies Act, 1999, §§ 270, 275, S.H. 189.

⁴⁶ *See* Mark Roe, *Some Differences in Corporate Structure: Germany, Japan, and the United States*, 102 *Yale L.J.* 1927 (1993).

⁴⁷ *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 *Va. L. Rev.* 549 (1984).

⁴⁸ *See* Black, *supra* note 32.

business community in America is very sensitive to business reputations with regard to the management of corporations.⁴⁹ The significance of these features is that adjudication costs are low in Delaware, both because of an efficient legal system and because of the parallel activity of extra-legal mechanisms. The presence of low adjudication costs justifies the adoption of a liability rule. Furthermore, negotiation costs as well are low in the United States, due to the presence of institutional investors and the efficiency of the capital markets. In such circumstances, market conditions resemble those of a market without transaction costs and, according to Coase's theorem, any solution would provide efficient results. Therefore, minimal and flexible protection, such as that provided by the fairness test, which the parties may use as a baseline, will be efficient in such conditions.

The United Kingdom shares many characteristics with the United States in terms of its capital markets and economic and social environments. The capital markets of the United Kingdom are very liquid and are comprised of mostly public corporations. Institutional investors have an extremely strong presence in the capital markets, controlling 70% of the shares of publicly-traded corporations.⁵⁰ However, the vast majority of judges lack any particular expertise in the realities of the corporate world; they strictly adhere to the principle of *stare decisis* and follow the rule of law as stated in previous cases, and they provide little guidance in their decisions for future claimants.⁵¹ These conditions imply high adjudicating costs and low negotiating costs, suggesting a preference for a property rule. However, the Corporation Act provides liability rule protection. Nonetheless, given the strong presence of institutional investors, the lack of adequate protection has led to private regulation, avoiding the need to rely on court rulings. The London Stock Exchange has shifted to property rule protection in conflict of interest transactions: corporations must submit all transactions involving a 10% shareholder to a general vote of the shareholders, with the interested shareholder not being allowed to vote.⁵²

The Canadian legal system is not as well-versed in corporate law and appraisals of value; the market for corporate control is almost nonexistent because of the high concentration of holdings in most corporations, and the

49 See Rock, *supra* note 34.

50 Bernard S. Black & John C. Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 Mich. L. Rev. 1997, 2001 (1994).

51 See Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* 312, 330-35, 352 (1997).

52 See *supra* note 6.

local capital market is inefficient.⁵³ In other words, this market is characterized by high adjudication costs without the efficient market forces that could prevent these costs. These findings suggest that property rule protection would be more efficient. However, the protections afforded to the minority shareholders under the Canadian Corporate Law, in most jurisdictions, are based on a liability rule type of protection.⁵⁴ Nonetheless, due to dissatisfaction with the protections afforded by Canadian corporate laws, bodies like the Ontario Securities Commission ("OS") shifted to a property rule: the rule requires majority of the minority approval in certain large related-party transactions and two-thirds majority of the minority if the transaction price deviates from the boundaries of the valuation prepared in connection with the related-party transaction.⁵⁵

The Israeli market shares many of the Canadian market's characteristics. However, the Israeli Companies Act did not adopt a straight property rule. It requires that conflicted transactions with a party holding more than 25% of the shares be approved by a majority vote that must include at least one-third of the disinterested shareholders; the transaction also must meet standards of fairness.⁵⁶

The cases of Delaware, the United Kingdom, Canada, and Israel demonstrate that the relative weight of the different characteristics — especially the quality of the courts — in a given system will affect the choice of the appropriate rule for the protection of the minority from the problem of conflicts of interest in publicly-traded corporations.

2. Closely-Held Corporations

In a comparison of Delaware, the United Kingdom, Canada, and Israel, it can be seen that while conflicts of interest in publicly-traded corporations are treated differently in the different jurisdictions, conflicts of interest in closely-held corporations are treated similarly. What accounts for this similarity in the face of the differing legal and economic conditions?

To begin with, closely-held corporations have small numbers of shareholders. This implies, on the one hand, very low negotiation costs at the stage of entering into the corporate contract, whether at the point of forming the corporation as promoters or incorporators or at the point

53 See Daniels & MacIntosh, *supra* note 5; Jeffrey G. MacIntosh, *The Role of Institutional and Retail Investors in Canadian Capital Markets*, 31 Osgoode Hall L.J. 371 (1993).

54 See Welling, *supra* note 43.

55 See *supra* note 44.

56 See Companies Act, 1999, §§ 270, 275, S.H. 189.

of buying a share in the corporation. The shareholders can negotiate the terms of their investment and every detail of the governance structure of the corporation. Shareholders who do not accept any specific governance arrangement or any investment term are not bound to join the corporation. Negotiations within a small group of people, in a setup where each person is free to accept or reject the terms of the transaction, entail very low costs. On the other hand, once the corporation is operating and running, the existing shareholders face very high negotiation costs when trying to resolve a problem of conflict of interest. At this stage, the shareholders are locked-in.⁵⁷ The small number of people in the group creates a very high risk of hold-out if a property rule is adopted. Imagine a requirement of approval by a majority of the minority for conflicted transactions in a corporation with three shareholders. In every transaction with one of the shareholders, each of the other two will have veto power over the execution of the transaction. Moreover, no market is there to ameliorate this problem.

Therefore, normally, disagreements, such as over approving conflicted transactions, will have to be referred to a third party. Liability rule protection provides just such a solution. Negotiations in the shadow of the liability rule strip the parties of their ability to hold-out. If unreasonable demands are made, the other party can always resort to the court. Although courts will have to perform a valuation, in the case of a closely-held corporation, that process will be simpler relative to publicly-held corporations, first, because of the smaller size and, second, due to the nature of businesses usually operated by closely-held corporations. As long as the courts have at least minimal effectiveness, the adjudication costs will be lower than the negotiation costs at the lock-in stage.

Indeed, if the parties want to adopt, *ex ante*, a property rule to govern their activities or even a liability rule that, instead of the court, uses an arbitrator familiar with the corporation's line of business, they can do so at very low negotiation costs. Moreover, even *ex post*, when the parties are already facing disagreement over a conflicted transaction, they can contract around the rule. For instance, assume that the corporation is in the high-tech development business and the court is asked to evaluate the transaction. Both parties realize that if the court is not competent enough to evaluate such a complicated business, the risk of error can fall on either side. Therefore, they can agree to move out of the court proceedings to an arbitration involving an expert in the high-tech area as arbitrator. In other words, in cases in which

⁵⁷ Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in the Close Corporation*, 24 J. Corp. L. 913 (1999).

adjudication costs might be high, the parties can avoid these costs through negotiations in the shadow of the liability rule.

Given that these features — adjudication costs are always lower than negotiation costs, coupled with the parties' ability to easily contract around the rule — are the same in most Western countries, all adopt the liability rule protection for conflicted transactions in closely-held corporations. In contrast, in publicly-traded corporations, whether adjudication costs are lower than negotiation costs will depend on the overall economic and legal conditions prevalent in the particular jurisdiction.

CONCLUSION

Conflicts of interest in corporate law can be addressed by two main alternatives: a requirement of a majority of the minority vote or the imposition of duties of loyalty and fairness. This article demonstrates that determining which of these rules is preferable is, in fact, a choice between liability rule protection and property rule protection. The choice depends on the total and relative transaction costs. These costs include both the negotiation costs attendant upon a property rule, as well as the adjudication costs associated with a liability rule. The sum of these costs is influenced by the efficacy of the judicial system and of extra-legal mechanisms, such as the market for corporate control, the capital market, and the types of investors active in the market. This explains the different solutions regarding publicly-traded corporations in different jurisdictions. However, sometimes conflict of interest situations share the same characteristics — as in the case of closely-held corporations — and different jurisdictions will thus apply the same solution to deal with the problem.

