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Intruders in the Boardroom: The Case of Constituency Directors

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INTRUDERS IN THE BOARDROOM: THE CASE OF CONSTITUENCY DIRECTORS

SIMONE M. SEPE*

ABSTRACT

Under current fiduciary rules, directors who fail to maintain an undivided loyalty to common shareholders are essentially "intruders," exposed to shareholder retribution and liability for breach of fiduciary duty.

This Article argues that the increasing appointment of "constituency directors" has made the fiduciary principle of undivided loyalty to the common shareholders both outdated and normatively undesirable. A "constituency director" is a director designated to the board by a particular constituency (or "sponsor"). These constituency directors are generally appointed to advocate for investors who are not common shareholders, such as preferred shareholders, creditors, unions, and even the federal government. Contrary to conventional scholarly accounts, these kinds of investors (non-common equity, or "NCE," investors) cannot always fully protect their interests through contracting alone. Thus, constituency directors are appointed to gain access to the added safeguards that only direct board advocacy can provide. By remedying this condition of "contractual failure," constituency directors make NCE investments worth undertaking where they otherwise might not be.

This analysis suggests that the liability constituency directors face under current fiduciary rules may reduce a corporation's access to important sources of capital. Hence, there is a normative case to be made for turning a director's obligation of undivided loyalty to the common shareholders into a default rule. This reform would allow constituency directors to properly advocate for their sponsors, bridging the gap between corporate practice and corporate law, to the benefit of all involved parties and society as a whole.

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INTRODUCTION

Just as soon-to-be Americans are required to take an "Oath of Allegiance" to the country that has granted them citizenship,[1] so too are individuals appointed to a corporation's board of directors required to subjugate their partisan interests to those of the corporation's common shareholders. No divided loyalties are permitted in the boardroom, regardless of how (or by whom) a director is designated.[2] Directors who fail to maintain an undivided loyalty to the common shareholders are essentially "intruders," exposed to shareholder retribution and liability for breach of fiduciary duty.[3]

This Article argues that the increasing appointment of "constituency directors" exposes flaws in the current law of fiduciary duty. The requirement that *all* directors be loyal to none but the common shareholders is no longer practically or normatively justified. This is not to

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1. *See* 8 C.F.R. § 337.1 (2008) (requiring soon-to-be-naturalized citizens to solemnly repeat the following language: "I hereby declare, on oath, that I absolutely and entirely renounce and abjure all allegiance and fidelity to any foreign prince, potentate, state, or sovereignty, of whom or which I have heretofore been a subject or citizen . . . "). Taking the Oath of Allegiance is a mandatory requirement for naturalization that officially implies a renunciation of one's previous citizenship. *See* Immigration and Nationality Act of 1952 § 337, 8 U.S.C. § 1448(b) (2012). However, the renunciation-related language of the Oath of Allegiance currently lacks effective enforcement so that, in practice, the United States allows dual citizenship if compatible with the laws of one's country of origin. *See* Karin Scherner-Kim, *The Role of the Oath of Renunciation in Current U.S. National Policy—to Enforce, to Omit, or Maybe to Change?*, 88 GEO. L.J. 329, 329–33 (2000); *see also* U.S. DEP'T OF STATE, Advice About Possible Loss of U.S. Citizenship and Dual Nationality, TRAVEL.STATE.GOV, http://travel.state.gov/law/citizenship/citizenship_778.html (last updated Jan. 11, 2013) (State Department acknowledgment that Americans may have other nationalities). Some scholars have argued that the U.S.'s novel toleration of dual nationality rightfully reflects changes in international relationships—which have eliminated many of the concerns historically associated with this status—as well as increasing globalization. *See* Peter J. Spiro, *Dual Nationality and the Meaning of Citizenship*, 46 EMORY L.J. 1411, 1416, 1461–63 (1997). Unfortunately, no similar effort has been made to take into account changed corporate relationships and business practices with respect to the divided loyalty issues that arise in the corporate context and are the focus of this Article.

2. *See infra* note 142 and accompanying text.

3. It is worth emphasizing at the outset of this Article's discussion that Delaware courts have generally restricted access to fiduciary benefits only to the common shareholders, excluding other classes of shareholders from fiduciary protection. *See, e.g.*, Solomon v. Armstrong, 747 A.2d 1098, 1124 (Del. Ch. 1999) (dismissing fiduciary claims by tracking shareholders (i.e., holders of equity claims tied to the performance of specific corporate assets) on the ground that conflicts among different shareholder classes are better dealt with contractually). In particular, Delaware courts have historically denied preferred shareholders the benefit of extra-contractual protection, admitting few exceptions to this long-standing position. *See, e.g.*, Wood v. Coastal States Gas Corp., 401 A.2d 932 (Del. 1979) (opining that preferred shareholders' participation rights are limited to those included in the articles of incorporation); Judah v. Delaware Trust Co., 378 A.2d 624, 628 (Del. 1977) (similarly limiting the rights of preferred shareholders to those provided for by the certificate of incorporation). *See also infra* note 158 and accompanying text (discussing recent cases on the preferred shareholders' corporate position).

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say this rule of fiduciary duty should be discarded. Rather, it should be viewed as the default, around which corporate parties may contract to further all parties' interests.

A constituency director is a director appointed to a board specifically to advance the interest of a certain constituency (the "sponsor" or the "designating investor"). These directors are most commonly appointed to represent investors who are not common shareholders,[4] such as preferred shareholders, creditors, unionized workers,[5] or even the federal government. This Article will refer to such classes of investors as "non-common equity" ("NCE"). NCE investors rely on the wide-ranging control over corporate affairs that only a director can exercise, in situations where contracting alone is inadequate to fully protect their interests. However, under current fiduciary rules, constituency directors who advocate for NCE investors face liability for breaching their obligation to be loyal only to common shareholders. But if NCE investors cannot gain the protections that constituency directors provide, such investors may decline to invest at all, reducing a corporation's access to NCE capital. In tough economic times such as the present, this is especially harmful.

Under the canonical view of corporate governance,[6] the fiduciary principle of undivided loyalty is justified as the necessary response to the severe contracting difficulties shareholders[7] face in addressing problems of

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4. Controlling shareholders or other particular classes of common shareholders also occasionally have recourse to specially appointed board designees. *See* Cyril Moscow, *The Representative Director Problem*, 16 INSIGHTS 12, 13 (June 2002). However, the appointment of this special group of constituency directors involves conflicts among investors sharing homogenous economic interests. Instead, the focus of this Article is on the appointment of constituency directors as a means to address conflicts among investors with divergent economic interests.

5. Workers, or employees, are investors in the sense that they contribute labor in exchange for the right to a fixed claim that has priority in the order of payment. *See* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1532 (1982); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1447 (1989) ("Holding firm-specific human capital is a way of investing in the firm."). Moreover, in today's corporate environment, unions, as representatives of employees and workers, increasingly act as business entities that provide a variety of services to both their members and corporations. *See* Matthew T. Bodie, *Mother Jones Meets Gordon Gekko: The Complicated Relationship Between Labor and Private Equity*, 79 U. COLO. L. REV. 1317, 1353 (2008) ("We need to recognize that unions, like their negotiating counterparts, are in business."); *see also infra* note 117 (discussing unions' management of employees' health and welfare trusts in the automotive industry).

6. *See infra* note 29.

7. For convenience, this Article will hereinafter use the term "shareholders" to refer exclusively to the common shareholders, consistently with Delaware courts' treatment of this shareholder class as the sole class that is entitled to fiduciary protection. As mentioned *supra* note 3, Delaware courts have generally restricted access to fiduciary benefits only to the common shareholders, excluding other classes of shareholders from fiduciary protection.

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managerial opportunism.[8] Indeed, as residual corporate claimants who bear the risk of failure and receive the marginal rewards of success, shareholders are concerned with all management actions.[9] This makes it unfeasible for them to control a manager's opportunistic behaviors solely through contracting because management of corporate affairs involves continuous decision-making. The right to elect the board of directors and the benefit of fiduciary protection are the mechanisms the law provides to address this condition of "contractual failure."[10] By vesting shareholders with the power to make adaptive (i.e., non-contractually specified) decisions—in the jargon of economists, *residual control rights*[11]—these mechanisms provide the added safeguards shareholders need to fully protect their corporate interests.

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8. Famously articulated by Adolph Berle and Gardiner Means over eighty years ago, the problem of managerial opportunism arises out of the separation of ownership from control that characterizes the modern corporation with dispersed shareholders. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 86–88 (1933). Michael Jensen and William Meckling subsequently formalized the shareholder-manager conflict in their agency theory of the firm. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309, 312–19 (1976). *See also infra* note 34 and accompanying text (discussing the various forms managerial opportunism vis-à-vis shareholders can take).

9. *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 404 (1983) (suggesting that shareholders' corporate position is unique because they are the only corporate constituency with a meaningful interest in every decision a solvent firm makes).

10. *See* Oliver E. Williamson, *Corporate Boards of Directors: In Principle and in Practice*, 24 J.L. ECON. & ORG. 247, 248–50 (2007) (describing the board as a means to provide "credible contracting support" to equity investments); Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1198–99 (1984) (suggesting that a condition of "contractual failure" justifies the attribution of board representation to corporate participants); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 91 (1991) (emphasizing that shareholders "receive few explicit promises. Instead they get the right to vote and the protection of fiduciary principles. . . ."); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 751–52 (1997) (arguing that because shareholders can be more easily expropriated than other investors, "[t]o induce them to invest in the first place, they need stronger protections, such as the duty of loyalty.").

11. Viewed through this lens, the shareholder franchise and fiduciary protection can be described as corporate law institutions implementing the theoretical predicate of the property right theory of the firm elaborated in the seminal work of economists Sanford Grossman, Oliver Hart, and John Moore. *See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990). Under this theory, when it is too costly for a party to negotiate for specific rights over another party's assets, it may be optimal to assign that party property rights giving her the power to exercise residual control over the assets. *See* Grossman & Hart, *supra*, at 692. Within this theoretical framework, the right to exercise residual control (over an asset) is defined as "the right to control all aspects of the asset that have not been explicitly given away by contract." Grossman & Hart, *supra*, at 695.

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As a corollary, NCE investors are not entitled to these sorts of additional protections. This is because, as fixed corporate claimants,[12] they are concerned with a more limited set of management actions and, therefore, theoretically, in a position to protect their interests by negotiating for specific contractual protections (i.e., *specific control rights*).[13]

While dominant in both legal doctrine and mainstream academic theories, this view reflects a corporate paradigm that has fallen out of step with the reality of an increasingly large share of U.S. corporations. Under this paradigm, equity is the principal source of capital,[14] company information is generally publicly available,[15] and the bottom-line protection for NCE investments comes from a corporation's net worth (i.e., the margin by which corporate assets exceeds corporate liabilities) ,[16] in addition to the ability to quickly exit a corporate investment.[17] But these assumptions are no longer generally applicable. In fact, none of these attributes are present in either venture-backed startups or declining

12. Similarly to creditors and workers, preferred shareholders can be described as fixed claimants to the extent that their payoff structure provides for the payment of fixed dividends and priority over common shares, as is most commonly the case. *See* ANDREW METRICK & AYAKO YASUDA, VENTURE CAPITAL & THE FINANCE OF INNOVATION 163–72 (Lacey Vitetta ed., 2d ed. 2011) (observing that all the various forms of preferred shares used in venture capital investments have concave (i.e., debt-like) features that make their holders highly sensitive to declines in asset value); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986) (comparing the disciplining effects that both debt and preferred shares with fixed dividends have on management).

13. *See* Grossman & Hart, *supra* note 11, at 602 (defining specific control rights as the contractually specified rights a party reserves over an asset).

14. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 10 (1991) (describing the need to raise huge amounts of equity capital as one of the technological changes that explains the rise of the modern corporation); Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1933 (1993) (same).

15. *See* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 529 (2002) (describing the "visible value" model of the corporation as the standard among legal and finance scholars). Under this model, inside (i.e., private) information is limited in importance and economic significance, short lived, and can easily be made publicly available. *See id.* at 529–30.

16. The common inclusion in debt contracts of covenants that require a corporation's net worth to exceed some minimum level is premised on this assumption. *See* JEAN TIROLE, THE THEORY OF CORPORATE FINANCE 85 (2006).

17. Pursuant to Hirschman's classic taxonomy of organizational means, exit allows individual members to terminate their relationship with an organization by withdrawing their participation. *See* ALBERT O. HIRSHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRM, ORGANIZATIONS, AND STATES 30 (1970). On the premise of the marketability of NCE investors' claims (regardless of whether these claims take the form of securities or investments in human capital), the classical paradigm of the corporation assumes that exit is always available to protect the interests of NCE investors. *See also infra* text accompanying notes 95–96 (discussing the implication of the *threat* of exit).

corporations—both of which are growing exponentially in importance in the U.S. economy.[18] Instead, such corporations are characterized by significant, company-specific information available only to management, low net worth, and high asset specificity (i.e., limited exit rights).[19] Because under these investment features investors tend to undervalue straight equity claims, NCE capital is often a primary source of funding.[20] Given the attributes that characterize these kinds of corporations, the apparently bright line that separates the contracting positions of shareholders and other capital providers begins to blur. NCE investors become potentially as sensitive to management actions—and, therefore, as exposed to contractual incompleteness issues—as shareholders. As a result, the ability of the contract alone to support NCE investments radically decreases, threatening the viability of such investments.

NCE investors thus appoint designated individuals to the board—constituency directors—to provide added safeguards and adaptive responses that cannot be secured through contract alone. For example, venture capitalists and private equity funds routinely seek representation on, if not control of, the boards of the startups they finance.[21] Creditors do the same, in an attempt to protect their interests in declining corporations.[22] Unions may also demand board representation in exchange for wage or other concessions to financially troubled corporations.[23]

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18. A recent study by the National Venture Capital Association found that "[t]he 500 largest public companies with venture roots" had a market capitalization of $2.8 trillion in 2010. NAT'L VENTURE CAPITAL ASS'N, VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL-BACKED COMPANIES TO THE U.S. ECONOMY 4 (6th ed. 2011), *available at* http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=786 (last visited Dec. 30, 2013). The study also found that "[f]or every dollar of venture capital invested from 1970 to 2010, $6.27 of revenue was generated in 2010." *Id.* at 2. Investments in distressed debt have also grown into "a critical component of the U.S. capital markets," especially in the aftermath of the recent financial crisis. Stephen G. Moyer et al., *A Primer on Distressed Investing: Buying Companies by Acquiring Their Debt*, 24 J. APPLIED CORP. FIN., no. 4, 2012, at 59; *see also* Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. APPLIED CORP. FIN., no. 4, 2012, at 23 (suggesting that the reorganization of distressed debt has had a fundamental impact in facilitating economic recovery after the financial crisis). It is also worth emphasizing that a growing share of venture capital investments takes the form of investments in distressed debt by so-called vulture funds. For a thorough description of U.S. vulture investing, see HILARY ROSENBERG, THE VULTURE INVESTORS (revised ed. 2000).

19. *See infra* Part I.B.2.

20. *Cf.* Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984) (exposing a pecking-order theory of corporate structures, under which in conditions of informational asymmetry, internal financing is preferred to debt claims and debt claims are preferred to straight equity).

21. *See infra* Part I.C.1.

22. *See infra* notes 109–10 and accompanying text.

23. *See infra* notes 111–17 and accompanying text.

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Yet the most innovative use of constituency directors has emerged in connection with the Troubled Asset Relief Program (TARP) that the U.S. Treasury employed to rescue troubled financial institutions during the financial crisis of 2007–2009.[24] In providing preferred stock financing to distressed financial institutions, the Treasury expressly bargained for the right to appoint board members in case of missed repayment deadlines. In implementing this provision, the Treasury has so far elected twenty-six board members to a total of fifteen financial institutions, including financial giant AIG.[25]

The existence of constituency directors, however, becomes problematic when those directors are also expected to abide by the principle of undivided loyalty to shareholders. If a conflict arises between the interests of the sponsor and the shareholders, the law currently requires that the interests of shareholders dominate, unless the sponsor has bargained for a specific course of action in her favor.[26] However, this is antithetical to the task NCE investors appoint constituency directors to perform, which is precisely to gain control over the corporate affairs beyond whatever contractual protections have been negotiated.[27]

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24. *See infra* notes 118–25 and accompanying text.

25. Specifically, the government has so far replaced twenty-four directors in fourteen troubled financial institutions that were rescued under the TARP's Capital Purchase Program, U.S. DEP'T OF THE TREASURY, TROUBLED ASSET RELIEF PROGRAM (TARP): MONTHLY REPORT TO CONGRESS—OCTOBER 2012 9 (Nov. 9, 2012), *available at* http://www.treasury.gov/initiatives/financial-stability/reports/Documents/October%202012%20Monthly%20Report.pdf [hereinafter TREASURY REPORT TO CONGRESS—OCT. 2012], and two directors at AIG, which was rescued under the TARP's Systemically Significant Failing Institutions Program. Press Release, AIG, U.S. Treasury Appoints Two Directors to AIG Board of Directors (Apr. 1, 2010), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=76115&p=irol-newsArticle&ID=1409189&highlight= [hereinafter AIG-Press Release].

26. Today more than ever, the courts of Delaware insist that *all* directors must be loyal only to the common shareholders. Beginning with the 2009 groundbreaking ruling in *In re Trados Incorporated Shareholder Litigation*, Delaware courts have moved beyond prior flat recitations of the undivided loyalty principle and made clear that a director's discretionary decision-making power can only be exercised for the benefit of the common shareholders, regardless of whether a director has been designated by a different corporate constituency, such as the preferred shareholders. *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, (Del. Ch. July 24, 2009); *see also infra* Part II.A.2–3 (discussing the *Trados* decision, and its social welfare implications, in detail). It also bears emphasis that, while a recent post-trial decision exculpated the *Trados* directors from liability for breach of fiduciary duties, in that decision the Delaware Court of Chancery reiterated the principle that the right to benefit from directors' discretionary decision-making only pertains to the common shareholders. *See In re* Trados Inc. S'holder Litig., No. 1512-VCL, 2013 WL 4511262, at *18 (Del. Ch. Aug. 16, 2013).

27. It is important to observe that the residual control NCE investors purport to obtain through the appointment of constituency directors entails both the right to exercise adaptive decision-making and the benefit of continuous, and timely, access to private company information. *See infra* Part I.C.3.

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These limitations do not simply create legal risks for NCE investors; they interfere with welfare maximization. Current doctrines tend to focus on the ex post consequences of vesting constituency directors with the power to exercise discretionary decision-making at the potential expense of shareholders. This focus overlooks the fact that, from an ex ante perspective, these contracting models solve the first-order problem of making NCE capital available to shareholders where it otherwise would not be, thus serving, rather than jeopardizing, shareholder interests and the interest of society as a whole.[28] Assuming that welfare-maximization is a normative goal of the law of fiduciary duty, there is then a case to be made for turning the principle of undivided loyalty into a default. Corporate actors should be enabled to bargain out of this principle by appointing constituency directors, and thus encourage investments that might otherwise be withheld.

This Article's discussion of constituency directors proceeds in three Parts. Part I discusses the rise of constituency directors and analyzes the fundamental role these actors play in today's corporate environment. Part II explains why the limitations arising from the fiduciary principle of undivided loyalty may compromise the effective use of constituency directors, potentially reducing a corporation's access to NCE capital. Methodologically, Part II relies on insights from game theory and a stylized example to illustrate the social welfare implications of the undivided loyalty principle. Lastly, Part III puts forward this Article's normative proposal and discusses related issues of implementation.

I. CORPORATE CONTRACTING AND CONSTITUENCY DIRECTORS

The canonical view of corporate governance relies on the fundamental assumption that all investors other than common shareholders are only concerned with *some* management actions and can thus fully protect their interests through contracting alone.[29]

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28. *See* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1314 (2008) (arguing that "[i]n some instances the efficient ex ante bargain may include terms that look inefficient ex post"). Moreover, ex post renegotiation will generally be available to the contracting parties in order to redress ex post inefficiencies. *See infra* Part II.B.3.

29. *See, e.g.*, William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1819 (2013) (observing that under standard accounts of corporate legal theory only the common shareholders are entitled to fiduciary benefits because their corporate contract "is almost entirely incomplete"; in contrast, no additional (i.e., non-contractually specified) rights are admitted in favor of other investors (e.g., lenders) because their contracts "approach completeness".); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1442–44 (1993) (arguing that shareholders are more vulnerable to the

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This Part challenges that assumption. In some corporate environments, such as startups and declining corporations, NCE investors are not only interested in a limited set of management actions, but, like the common shareholders, are interested in *all* management actions. In these contexts, NCE investors face contracting problems virtually as serious as those facing shareholders.

Such a reframing sheds much needed light on the appointment of constituency directors who are expected to represent the interests of NCE investors at the board level. As the ensuing discussion will show, in startups and declining corporations, NCE investors appoint constituency directors to secure protections that corporate contracting alone fails to provide.

A. The Canonical View of Corporate Governance

Corporate governance is the complex set of contractual and legal mechanisms that is designed to control the conflicts of interests that may arise among the several corporate constituencies. These conflicts are now well understood through agency theory, which has come to provide the standard analytical framework in corporate law and economics.[30] The premise of agency theory is that self-interested agents may have incentives to exploit private information to opportunistically deviate from their principal's best interest.[31] Viewed through this lens, corporate conflicts fall into two main sets: vertical and horizontal agency problems.[32]

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risk of managerial misconduct and, at the same time, unable to bargain for effective protection against this risk); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 314–15 (1999) (suggesting that unlike other corporate participants, shareholders face "unique vulnerabilities" that cannot be solved through explicit contracts).

30. *See, e.g.*, Blair & Stout, *supra* note 29, at 248 (describing the principal-agent model as the primary analytical framework used in contemporary discussions of corporate governance); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 623 (2004) ("Agency cost theories of the firm dominate the modern literature of corporate law and economics.").

31. The standard reference is to the work of Jensen and Meckling. *See* Jensen & Meckling, *supra* note 8, at 308–09.

32. *See* Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 42–45 (2006) (focusing on vertical and horizontal agency problems in the venture capital context); Simone M. Sepe, *Corporate Agency Problems and Dequity Contracts*, 36 J. CORP. L. 113, 116–17, 129–33 (2010) (discussing vertical and horizontal agency problems in publicly held corporations). Some scholars refer to vertical and horizontal agency problems as, respectively, "managerial" and "financial" agency problems. *See* George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155, 2158–59 (1994). While the label may change, the substance of this distinction does not.

1. *Vertical and Horizontal Agency Problems*

Vertical agency problems concern the central conflict of interest that arises in the modern corporation between the shareholders, as principals, and managers, as agents.[33] Managers may pursue their own interest at the shareholders' expense in a variety of ways. For example, they may shirk, pay themselves excessive compensation, undertake conflict of interest transactions, consume perquisites, engage in lavish empire building, pursue pet projects, or entrench themselves at the expense of shareholders.[34] In all these situations, managers avoid taking actions that would increase firm value—a problem generally labeled by economists as engaging in "insufficient effort."[35]

Horizontal agency problems concern, instead, the conflicts that arise between the shareholders, as agents,[36] and the other parties who provide capital to the corporation—be it in the form of debt, hybrid financial instruments such as preferred shares, or even labor[37]—as principals. Here, shareholders have incentives to take actions, through their managers,[38] that

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33. *See* Bartlett, *supra* note 32, at 42, 51–56 (defining vertical agency problems as those "posed by the delegation of corporate authority to unrelated managers"); Sepe, *supra* note 32, at 116, 129–31 (defining vertical agency problems as those arising out of the difficulty investors-principals encounter in inducing the managers-agents to behave).

34. For a detailed review of the many forms managerial opportunism can take, *see* Shleifer & Vishny, *supra* note 10, at 742–43.

35. In economics, the term "effort" is broadly used to refer to any action the agent takes to advance the principal's interest. *See* JOHN ROBERTS, THE MODERN FIRM: ORGANIZATIONAL DESIGN FOR PERFORMANCE AND GROWTH 126–27 (2004). Conversely, "insufficient effort" defines any action of the agent that does not advance the principal's interest.

36. Agency theory conceives of the firm as a "legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals (some of whom may 'represent' other organizations) are brought into equilibrium within a framework of contractual relations." Jensen & Meckling, *supra* note 8, at 311. This view of the firm as a "nexus of contracts" places all corporate participants on equal footing, conceiving of all of them as factors of production. *See* Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1266–67, 1269–73 (1999). In the legal rendering of this theory, however, shareholders retain a privileged corporate position as holders of ownership-like features. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 548, 564 (2003). This explains why other capital providers are concerned with the ability of shareholders, as firm-owners, "to enhance or destroy the value of her investment." *See* Bartlett, *supra* note 32, at 44.

37. *See supra* note 5 (explaining why workers can be considered as providers of capital).

38. Since control over corporate affairs is exclusively vested in the managers in the public corporation, as a practical matter, managers, rather than shareholders, have the power to decide whether to pursue actions that are detrimental to the interests of NCE investors. *See* Sepe, *supra* note 32, at 125. To overcome the impasse created by this discrepancy between practice and theory of corporate agency relationships, law and economics scholarship on horizontal agency problems has traditionally assumed away the central agency problem between shareholders and managers. *See* Triantis, *supra* note 32, at 2158 (explaining that financial (i.e., horizontal) agency problems arise under

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enrich themselves at the expense of these other capital providers (i.e., NCE investors).[39] While there are many ways managers may do this,[40] the classic example is to take actions that increase corporate risk. Indeed, as residual claimants protected by limited liability, shareholders have a preference for high-risk, high-return investments.[41] In contrast, NCE investors oppose risky actions that increase the likelihood that a corporation may fail to meet its fixed obligations[42]—including interest and principal owed to debtholders, fixed dividends owed to preferred shareholders, and wages owed to employees.

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the assumption that "managers are perfect agents of their principals, the shareholders"); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1077 (1995) (suggesting that the literature on shareholder-debtholder conflicts has developed by assuming away the shareholder-manager conflict). This is, however, a rather wanting approach, because in actuality horizontal and vertical agency problems tend to simultaneously affect corporate relationships. Moving from these observations, in my prior work I suggested that the theoretical framework of common agency might provide a better positive and normative account of corporate agency problems than the traditional principal-agent paradigm. *See* Sepe, *supra* note 32, at 124–33. In economics, common agency is said to arise when several independent principals with divergent interests hire a single agent to perform multiple tasks. *See* B. Douglas Bernheim & Michael D. Whinston, *Common Agency*, 54 ECONOMETRICA 923 (1986) (pioneering the study of common agency). Consistent with this paradigm, in the modern corporation managers act as both agents of shareholders and NCE investors. On the one hand, they exercise delegated authority over the enterprise on behalf of the shareholders. On the other hand, in this position, they execute the contract of NCE investors with the firm (i.e., the shareholders as firm-owners).

39. *See* Bartlett, *supra* note 32, at 42, 61–64 (defining horizontal agency problems as those arising out of interinvestor conflicts); Sepe, *supra* note 32, at 116 (explaining that horizontal agency problems arise because different types of investors have "divergent preferences over desirable managerial actions").

40. For example, managers may benefit shareholders at the debtholders' expenses by paying out excessively large dividends, issuing additional debt, or substituting safe projects with riskier ones (i.e., engaging in what economists call "asset substitution" or "overinvestment"). *See* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979). Preferred shareholders may be exposed to similar risks, since their payoff structure often resembles that of debt more than that of common stock. *See supra* note 12. Likewise, managers may enrich shareholders by exploiting employees, for example by paying them low wages, forcing them to work long hours, and so forth. *See* John Armour et al., *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 35, 36 (Reinier Kraakman et al. eds., 2d ed. 2009).

41. As residual claimants, shareholders expect to reap all the upside from these strategies, while limited liability protects them from downside risks. *See* Jensen & Meckling, *supra* note 8, at 334–37 (offering the standard economic reference on the conflict arising from the divergent risk preferences of residual claimants and fixed claimants).

42. In this light, paying out excessive dividends or undertaking risky projects are both actions that increase corporate risk. Excessive dividend payment makes a corporation's fixed claims riskier "indirectly," "without per se increasing the riskiness of the firm's income flow." *See* TIROLE, *supra* note 16, at 85. Undertaking risky projects makes a corporation's fixed claims riskier "directly," by causing the firm's income to become riskier. *See id.*

2. *Contractual Incompleteness and Investor Remedies*

Incomplete contract theory[43] helps to explain the issues confronting shareholders and NCE investors in their respective attempts to mitigate vertical and horizontal agency problems.[44] At their core, both of these problems are in fact manifestations of the inherently incomplete nature of long-term contracts. If parties could contract for every possible contingency, then there would be no room for corporate opportunism of any form. Nevertheless, conventional wisdom states that the degree of contractual incompleteness faced by shareholders, as residual claimants, is more severe than that faced by NCE investors, as fixed claimants.[45]

In financial terms, equating shareholders to residual claimants means that shareholder value is perfectly and positively correlated with asset value. Hence, in order to fully protect their investment expectations, shareholders should theoretically specify in advance the consequences to management of any given action, as all management actions affect asset value, to a greater or lesser extent. But, of course, such a contract is unattainable as the management decision-making process is infinite and continuous, with every tiny action having potentially some, even minor, impact on asset value. Incentive-compatible contracts that condition

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43. Although a general definition of incomplete contract theory is absent in the literature, this theory relates to the central notion that *transaction costs* reduce a relationship's feasible outcomes by imposing restrictions on the set of allowable contracts. *See* Jean Tirole, *Incomplete Contracts: Where Do We Stand*? 67 ECONOMETRICA 741, 743 (1999). To this extent, modern incomplete contract theory builds on the concept of transaction costs first introduced by Ronald Coase and later developed by Oliver Williamson. *See* R.H. Coase, The *Nature of the Firm*, 4 ECONOMICA 386 (1937); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985). Under this concept, the costs of bounded rationality (i.e., foreseeing contingencies), specification (i.e., writing contingencies) and verifiability (i.e., enforcing contractually specified contingencies) make it impossible for parties to write fully state-contingent agreements, engendering both ex ante and ex post inefficiency. *See* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 23–24 (1995).

44. It is worth observing that the law and economics literature on the theory of the firm has developed by combining elements of agency theory and incomplete contract theory. *See* Blair & Stout, *supra* note 29, at 261–63 (describing this combined model as "the grand-design principal-agent model"). Economically, however, these are two distinct theories. *See* HART, *supra* note 43, at 21–23. Under agency theory, contracting costs only arise from the difficulty of observing the agent's actions and other relevant contingencies. *See id.* at 21. Incomplete contract theory, instead, is premised on the assumption that even observable contingencies might be not "verifiable," i.e., effectively communicated to third parties with outside authority, such as courts. *See id.* at 23.

45. *See, e.g.*, Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 25 (1991) (arguing that the contracting problems facing "[o]ther constituencies . . . can be solved at far less cost than those confronting shareholders"); Bratton & Wachter, *supra* note 29, at 1839 (contrasting the corporate interests of shareholders, which are "so broad as to be non-contractible", with those of preferred shareholders, which can instead be bargained for and therefore protected by contract).

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management compensation on firm performance (i.e., equity-based compensation schemes) can mitigate the costs associated with incomplete contracting, but never fully solve the problem.[46] Therefore, shareholders need other forms of protection to fill the gap that contracting cannot.

NCE investors, on the other hand, are not concerned with the daily fluctuations in asset value, but rather are concerned with the repayment of fixed claims. This theoretically reduces the set of management actions that are of interest to NCE investors to a set small enough to be contracted for in advance.[47] Consequently, such investors can protect their claims through a combination of specific contractual provisions and price-based compensatory mechanisms (e.g., increased interest rates).[48] Moreover, while the shareholders' investment is locked in for the life of the corporation, the corporate relationship with NCE investors is subject to periodic renewals.[49] This implies that, unlike shareholders, NCE investors have the ability to renegotiate original contractual terms to meet changes in the external state of the world.[50]

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46. *See* MATHIAS DEWATRIPONT & JEAN TIROLE, THE PRUDENTIAL REGULATION OF BANKS 120 (1994) (suggesting that the difficulty of verifying manager performance limits the effectiveness of incentive-based compensation in providing adequate discipline); Mathias Dewatripont & Jean Tirole, *A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence*, 109 Q. J. ECON. 1027 (1994) (providing a formal analysis of the same argument).

47. *See* Jean Tirole, *Corporate Governance*, 69 ECONOMETRICA 1, 31 (2001) (explaining that non-controlling stakeholders (i.e., NCE providers) can contractually "circumscribe the action set available to the controlling stakeholder by ruling out those actions that are more likely to involve strong negative externalities on other stakeholders"); Macey, *supra* note 45, at 36 ("Nonshareholder constituencies can protect themselves against virtually any kind of managerial opportunism by retaining negative control over the firm's operations.").

48. For example, anti-dilution clauses provide, in general, a valuable tool against management actions that may dilute the value of debt or preferred shares. *See* Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure*: *An Empirical Investigation*, 64 J. FIN. 1657, 1663 (2009) (finding that 90% of debt includes provisions limiting a borrower's total debt). Similarly, the posting of collateral, when available, significantly reduces the scope of asset substitution strategies. *See* Michael Bradley & Michael R. Roberts, The Structure and Pricing of Corporate Debt Covenants 17 (May 13, 2004) (unpublished manuscript), *available at* http://ssrn.com/abstract=466240 (finding that loans to firms with higher cash flow volatility (i.e., increased asset substitution risk) are more likely to include dividend restrictions and to require collateral). Along the same line, employees can and do bargain for contractual protection against the risk of shareholders' expropriation, often just adhering to the collective labor contracts agreed upon between unions and corporations. Moreover, NCE investors can always demand increased prices as compensation for these and others forms of horizontal agency problems. *See* Bainbridge, *supra* note 29, at 1443 (arguing that nonshareholder constituencies "can protect themselves by adjusting the contract price to account for negative externalities imposed upon them by the firm"); Sepe, *supra* note 32, at 133–34 (explaining that managerial opportunism is a specific investment risk which increases firms' cost of capital).

49. *See* Shleifer & Vishny, *supra* note 10, at 751–52; *see also* Williamson, *Corporate Governance*, *supra* note 10, at 1210.

50. *See* BERNARD SALANIÉ, THE ECONOMICS OF CONTRACTS: A PRIMER 194 (2d ed. 2005) ("[R]enegotiation allows the parties to react to unforeseen contingencies."); Klaus M. Schmidt,

This analytical framework explains the different legal protection afforded to shareholders and NCE investors. Because of the contracting problems affecting shareholders, corporate law grants them the safeguard of "internal governance mechanisms":[51] general-purpose control instruments operating within the firm and designed to protect shareholder investments. The most important among these mechanisms are the right to elect the board of directors[52] and the fiduciary duties owed by directors to shareholders.[53] The board of directors is the organizational body charged with protecting the investment expectations of shareholders[54]—acting as

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Contract Renegotiation and Option Contracts, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 432 (1998) ("Renegotiation is beneficial and necessary to achieve an *ex post* efficient outcome in every state of the world."). The frequent renegotiation of private debt contracts is consistent with these theoretical assumptions. *See* Michael R. Roberts & Amir Sufi, *Renegotiation of Financial Contracts: Evidence from Private Credit Agreements*, 93 J. FIN. ECON. 159, 160 (2009) (reporting that more than 90% of private debt with stated maturity exceeding one year are renegotiated).

51. *See, e.g.*, Simone M. Sepe, *Regulating Risk and Governance in Banks: A Contractarian Perspective*, 62 EMORY L.J. 327, 331, 354 (2012) (defining internal governance).

52. The shareholders' power to elect the board includes the symmetric power to remove directors if shareholders are displeased with their activity. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985) ("[T]he powers of corporate democracy are at [the shareholders'] disposal to turn the board out."). Removal, however, must generally be for cause. *See* Campbell v. Loew's, Inc., 134 A.2d 852, 858 (Del. Ch. 1957).

53. Shareholders enjoy other internal governance mechanisms, such as the right to vote on major corporate transactions, including charter amendments, mergers, sale of assets, and corporate dissolution. *See* Edward Rock et al., *Significant Corporate Actions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 131, 132 (Reinier R. Kraakman et al. eds., 1st ed. 2004) ("[A]ll corporate actions that are large, investment-like, and potentially self-interested are candidates for shareholder approval. . . ."). Further, under some statutes, shareholders can directly intervene in the governance of the corporation through the amendment of corporate bylaws. *See, e.g.*, CAL. CORP. CODE § 211 (West 1990); DEL. CODE ANN. tit. 8, § 109(a) (West 2011); N.Y. BUS. CORP. LAW § 601(a) (McKinney 2003). Lastly, shareholder-initiated proposals are possible under Rule 14a–8 of the federal proxy rules (i.e., the "town meeting rule"), which gives shareholders voice in several governance subjects, including executive compensation, board organizational rules, and anti-takeover measures. *See* 17 C.F.R. § 240.14a-8 (2011).

54. *See* Mark J. Roe, *The Institutions of Corporate Governance*, *in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371, 379 (Claude Ménard & Mary M. Shirley eds., 2005) ("The board is the quintessential vertical corporate governance institution."); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) (describing the view that the board is charged with addressing the vertical agency problem between shareholders and managers); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 ECON. POL'Y REV., Apr. 2003, at 7, 9 (viewing the board as "an endogenously determined institution that helps to ameliorate the agency problems that plague any large organization"); Williamson, *Corporate Governance*, *supra* note 10, at 1210 (describing the board of directors as a governance structure whose principal purpose is to safeguard the interests of the shareholders).

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the vigilant internal monitor of management on the one hand and being empowered to exercise discretionary power on the other.[55] Fiduciary duties set guidelines for a board's exercise of such power in disciplining management and, more generally, filling in the gaps of the shareholder contract.[56] On the contrary, the rights of NCE investors are limited to those explicitly contracted for, on the assumption that these investors, unlike shareholders, can be fully protected by specific contractual provisions.[57]

By drawing such a line between the remedies available to shareholders and NCE investors to protect their respective corporate interests, the law assigns the former a privileged corporate position as property right holders.[58] The exclusive entitlement to internal governance mechanisms is the instrument through which the law grants shareholders residual control over the firm—defined here as the right to make adaptive decisions in response to unforeseen contingencies. Because of the theoretically less

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55. *See, e.g.*, Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV., Jan. 2002, at 1, 8 (2002); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 313 (1983) (describing the board as the apex of the corporation's "decision control system" exercising both monitoring powers and ultimate decision-making authority). Delegating the monitoring of managers to the board originates its own set of agency problems. *See infra* text accompanying notes 231–32 (discussing possible solutions to such problems). Nevertheless, an enduring understanding is that corporate decision-making improves when people who make decisions are separated from those who ratify them. *See* Fama & Jensen, *supra*, at 303–04, 307–08.

56. The work of Easterbrook and Fischel provides the standard law and economics reference. *See* Easterbrook & Fischel, *supra* note 5, at 1432–34 (first outlining this view of corporate fiduciary duties); EASTERBROOK & FISCHEL, *supra* note 10, at 15–17, 92 (reproducing the same argument).

57. *See, e.g.*, Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989) (explaining that the rights of corporate debtholders are limited to those arising from the contract governing the debtor–creditor relationship); Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 790 (Del. Ch. 2004) (stating that creditors do not need additional protection because they are already "protected by strong covenants, liens on assets, and other negotiated contractual protection"). Preferred shareholders (as well as other classes of non-common shareholders) are treated similarly by the courts. *See infra* text accompanying note 158. Likewise, courts exclude employees from protection extending beyond their bargained-for rights. *See, e.g.*, Merola v. Exergen Corp., 668 N.E.2d 351, 355 (Mass. 1996).

The second step of the argument against the extension of shareholder-like privileges to NCE investors is that such investors already benefit from other bodies of law that effectively protect their interests. *See* Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 52–58 (2004) (providing an excellent summary of the arguments scholars have offered to explain why non-shareholders do not need corporate protection). For example, employees benefit from extensive protection under "pension laws, health and safety laws, minimum-wage laws, injury and disability compensation arrangements, antidiscrimination laws, sexual harassment laws, tort laws, and so on." *Id.* at 53. Similarly, fraudulent conveyance laws, the practice of "piercing the corporate veil," and regulatory restrictions provide creditors with specific legal remedies to protect their interests. *Id.* at 54. Courts have also employed this additional argument to deny extension of non-contractual protection to fixed claimants. *See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007).

58. *See supra* note 11.

severe contracting problems facing NCE investors, their protection is instead limited to the specific control rights they bargain for ex ante, with the exclusion of any adaptive decision-making power.

B. The Limits of Corporate Contracting

The canonical view of corporate governance thus draws a bright line between shareholders' rights, which occupy the center stage of corporate law, and the rights of NCE investors, which are instead relegated to the realm of contract law.[59] In modern corporations, however, there exist circumstances that escape this rigid categorization, challenging both its accuracy and economic underpinnings. In these circumstances, the long-held assumption that all investors other than common shareholders can fully protect their interests through contracting alone simply no longer holds true.

1. Sensitivity to Management Actions

Figure 1 below is useful to begin to illustrate the circumstances that in modern corporations may blur the alleged distinction between the contracting positions of shareholders and NCE investors.

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59. *See* Bratton & Wachter, *supra* note 29, at 1819 (suggesting that in the classic account of corporate legal theory, a "well-understood wall" separates the legal treatment of shareholders and lenders (i.e., fixed claimants), with the shareholders being "corporate" and the lenders being "contractual"). Bratton and Wachter argue that this account is ill suited to capture the position of preferred shareholders, "their participation being both corporate and contractual." *See id.* at 1819. This Article extends that claim by showing that other fixed claimants may share the hybrid position of preferred shareholders depending on the underlying corporate context.

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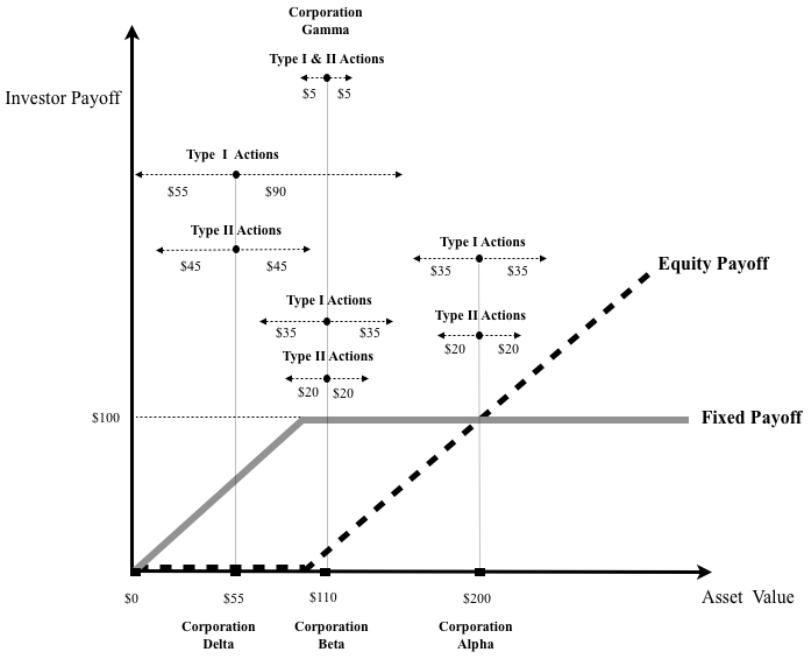

Fig. 1. Payoff sensitivity to management action

Figure 1 shows the sensitivity of investor payoff to management actions in four different corporations—Alpha, Beta, Gamma, and Delta—each having one category of outstanding fixed (i.e., NCE) claims.[60] The *x*-axis represents asset value. The *y*-axis represents investor payoff. Note that $100 is the face value of the fixed claims in each corporation. The portion of the *x*-axis that is included between the face value of the fixed claims ($100) and each corporation's asset value can be interpreted as that corporation's net worth. The Fixed Payoff line and Equity Payoff line, respectively, show fixed and equity payoff at each possible asset value level.

The dashed horizontal lines with double-ended arrows represent corporate risk, expressed in the figure as the range of positive or negative variations in asset value that may follow riskier (Type I) or safer (Type II) management actions.[61] For example, in the case of Corporation Alpha,

60. For the purpose of the ensuing discussion, these outstanding fixed claims can be equally interpreted as debt, preferred stock, or employee wages.

61. This representation of corporate risk reflects the general finance theory view of risk as "the

corporate risk is such that asset value can vary up to $35 upward or downward if management takes a riskier Type I Action, or $20 upward or downward if management takes a safer Type II Action.[62] The volatility of corporate assets[63] is what determines the magnitude of corporate risk across the four corporations,[64] implying that some assets (and, therefore, industries) are more likely to be subject to value fluctuations than others. Lastly, the distribution of possible realizations at each given level of corporate risk is determined by management effort.[65] High effort is more likely to result in positive realizations (moving to the right on the *x*-axis) and, conversely, low effort is more likely to result in negative realizations (moving to the left on the *x*-axis).[66]

Consider first the case of Corporation Alpha, which has an asset value of $200. Here, the general assumption about the limited sensitivity of NCE investors to management actions remains intact. This is because, with an asset value of $200 and a corporate risk of either $35 or $20, no management action can jeopardize the repayment of fixed claims, even when management exerts low effort. This can be seen by plotting the intersections between Corporation Alpha's corporate risk lines (i.e., "Type I Actions" and "Type II Actions" lines) and the fixed payoff line on the vertical axis. As shown by the figure, NCE investors are fully insulated from the effects of management action.

Consider now, however, Corporation Beta, which has an asset value of $110. Since the corporate net worth is only $10 in this case, one can think of Corporation Beta as a "declining corporation"—a corporation that could

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extent of uncertainty associated with an asset's returns." *See* RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 85 (1993).

62. For simplicity's sake, in this discussion, we can just say that in Corporation Alpha, corporate risk is $35 under Type I Actions and $20 under Type II Actions. The same simplified terminology will be adopted to describe corporate risk in Corporations Beta, Gamma, and Delta.

63. In this Article, the term "asset volatility" refers to the volatility of corporate assets that is independent from other endogenous corporate decisions, such as, for example, capital structure choices. *See* Hayne E. Leland & Klaus Bjerre Toft, *Optimal Capital Structure, Endogenous Bankruptcy, and the Term Structure of Credit Spreads*, 51 J. FIN. 987, 987–88 (1996).

64. This difference in the magnitude of corporate risk is expressed in the figure by the different lengths of the double-arrowed lines across the four corporations. For example, the range of asset value variations that may follow riskier management actions is $70 in Corporation Alpha, while it is $145 in Corporation Delta.

65. *See* Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 75–76 (1979) (modeling the principal's monetary payoff as a function of both the agent's unobservable actions (i.e., effort) and a random state of nature, with the expected realization of the principal's monetary payoff increasing in the agent's effort level).

66. For example, in the case of Corporation Alpha's Type I Actions, high effort will make a realization in the range [0, $35] more likely, while low effort will make a realization in the range [-$35, 0] more likely.

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soon enter financial distress.[67] Corporate risk is the same for Corporation Beta as it was for Corporation Alpha: $35 or $20, depending on whether management takes a riskier or safer action. This means that Corporation Alpha and Corporation Beta share the same asset volatility. Thus, Corporation Beta can be understood as either a firm operating in the same industry as Corporation Alpha, but with a lower net worth than Alpha, or as Corporation Alpha itself upon difficult financial times. In this scenario, the assumption that NCE investors are virtually insensitive to management actions no longer holds true. If we plot the intersection between Corporation Beta's corporate risk lines and the fixed payoff line on the vertical axis, we can see that the fixed payoff will be lower than $100 for any Type I Action that makes a realization in the range [-$35, $0] more likely as well as any Type II Action that makes a realization in the range [-$20, $0] more likely.

Compare now Corporation Beta and Corporation Gamma, which have the same asset value: $110. For Corporation Gamma, however, the nature of the corporate assets is such that corporate risk is only $5, regardless of whether management takes riskier or safer actions.[68] Given these corporate features, no management action can jeopardize the repayment of the fixed claims. Indeed, the fixed payoff remains $100 for any point of Corporation Gamma's corporate risk line.

Finally, consider Corporation Delta, which has an asset value of $55 and, therefore, a negative net worth. While this makes Corporation Delta technically insolvent, it is worth observing that technical insolvency is quite common in the early stages of many startups.[69] This is because startups often experience years of operating losses and negative cash flows before generating any significant revenue.[70] As for Corporation Delta's

67. *See* Aswath Damodaran, Valuing Distressed and Declining Companies 4–5 (June 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1428022 (defining a declining corporation as one with stagnant revenues, shrinking or negative operating margins, asset divestitures, big payouts, and overwhelming debt burdens). Relatedly, distressed firms in this Article are defined as declining firms that have difficulties meeting their financial obligations.

68. To this extent, Corporation Gamma can be interpreted as, for example, a company in the wholesale industry, which has relatively low volatility. *See* Zijun Wang, *Dynamics and Causality in Industry-Specific Volatility*, 34 J. BANKING & FIN. 1688, 1693 (2010) (providing empirical evidence that volatility values for the wholesale industry are lower than the average and market volatility values).

69. *See* J. CHRIS LEACH & RONALD W. MELICHER, ENTREPRENEURIAL FINANCE 533 (4th ed. 2009).

70. *See* Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1175. Research and development expenses, marketing costs, and the hiring of employees absorb most of the available funds of early-stage startups. *Id.* For this reason, "[s]tart-ups can burn through millions of dollars a month before having any sort of revenue-generating product or service to market." *Id.* at 1175.

corporate risk, asset value can vary up to $50 downward and $90 upward under Type I Actions,[71] while it can vary up to $20 downward or upward under Type II Actions. In this corporate context, any management action will have an impact on the NCE investors' payoff. As shown by the figure, with negative corporate net worth, for every one dollar increase in asset value, the fixed payoff value correspondingly rises by one dollar.

Thus, in contrast to conventional accounts of corporate governance, these examples indicate that, for NCE investors, sensitivity to management actions (i.e., both risk and effort choices) is a dynamic feature that varies with firm-specific determinants in a continuum that goes from low to high sensitivity. In particular, as shown by Figure 1, two factors that influence the degree to which NCE investors are affected by management decision-making are (a) a corporation's net worth and (b) asset volatility. A corporation's net worth determines the financial cushion that is available to absorb losses from investments.[72] The lower the corporate net worth, the more likely it is that management actions may jeopardize the repayment of fixed claims.[73] Asset volatility determines the relative impact of management actions on asset value. This impact will tend to be greater when assets are more volatile because this feature increases the possible variations in asset value that may result from any given management action.

2. *Startups and Declining Corporations*

The above analytical framework suggests that there are at least two well-identified corporate contexts in which NCE investors are highly sensitive to management decision-making: startups and declining corporations.[74] Both contexts are characterized by low net worth and high

71. Because of limited liability, a zero valuation is the worst-case scenario. This explains why the range of asset value variations under riskier management actions is asymmetric in this case.

72. It is worth observing that when a corporation has multiple outstanding fixed claims at one time, for each category (or class) of fixed claimants, the net-worth-to-fixed-claims ratio provides the actual measure of that corporation's available financial cushion. That is, for each category of fixed claimants, a corporation's financial cushion will be provided by the corporation's net assets and subordinated fixed claims that are available to absorb losses ahead of the category of fixed claims at hand. As an example, imagine a corporation with three categories of fixed claims: labor, debt, and preferred shares. Using L for labor, D for debt, P for preferred shares, and E for equity, the following is the order of priority of payment: L, D, P, E. The net-worth-to-fixed-claims ratio for each category of fixed claims will be as follows: (i) for L: $\frac{D+P+E}{L}$; (ii) for D: $\frac{D+P+E}{D}$; and (iii) for P: $\frac{E}{D}$.

73. *See* TIROLE, *supra* note 16, at 105–06 ("The borrower's basic financial strength and ability to support debt and absorb downturns lie in its net worth.").

74. A fortiori, NCE investors are highly sensitive to management actions in distressed corporations. *See supra* note 67.

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asset volatility, and thus NCE investments are likely to be more affected by any management action as stated above. In startups, low net worth is generally attributable to asset value being dependent on difficult-to-evaluate intangible assets, such as technological know-how, patents, trade secrets, and human capital.[75] In declining corporations, it is instead the result of declines in asset value caused by exogenous shocks (e.g., a decrease in demand for corporate products), endogenous factors (e.g., mismanagement), or, most frequently, a combination of the two. Low net worth combines in both cases with high asset volatility, since intangible assets, in the case of startups, and distressed assets, in the case of declining corporations, are more subject to value fluctuations than are other assets.[76]

Startups and declining corporations are further characterized by investments with a high degree of information asymmetry, where much of the most valuable information is available only to management. Indeed, in a corporation with low net worth and high asset volatility, investors are motivated to invest by a company's "hidden corporate value." As explained by Bernard Black and Reinier Kraakman, corporate value is "hidden" when "a firm's true economic value is visible to well-informed corporate directors [and managers],"[77] while the firm's investors are left with only an imperfect inference of that value. It is self-evident that startups fit into this corporate model. Startups are intrinsically characterized by a high degree of information asymmetry between management and investors, which tends to remain for a significant period

75. *See* Ibrahim, *supra* note 70, at 1175.

76. In the case of intangible assets, the assumption is that volatility is higher because multiple idiosyncratic factors combine to determine asset value. Consistent with this theoretical assumption, Hewlett-Packard, for example, had a twenty-four percent stock price decline that corresponded to a nearly sixty percent drop in the value of its intellectual property and intangible assets in 2008–2009. *See* GORDON V. SMITH & RUSSELL L. PARR, INTELLECTUAL PROPERTY: VALUATION, EXPLOITATION, AND INFRINGEMENT DAMAGES 97 (4th ed. 2011). In declining corporations, instead, higher volatility is likely to arise because of the shareholders' preferences for riskier projects. *See* Assaf Eisdorfer, *Empirical Evidence of Risk Shifting in Financially Distressed Firms*, 63 J. FIN. 609, 610 (2008) ("As high risk benefits the shareholders of distressed firms, an increase in the volatility of a project may provide an opportunity for shareholders to increase value by investing in a risky project.").

77. Black & Kraakman, *supra* note 15, at 521–22. The hidden value model of the corporation rests on the assumptions that company-specific private information is (i) severe, either because most information is soft or corporate value would be diminished by premature disclosure; (ii) significant, in that the divergence between actual corporate value and market value is potentially large; and (iii) long-lasting, as actual corporate value can remain hidden for a long time before becoming "visible" to outsiders. *See id.* at 529–30; *see also infra* note 92 (defining "soft information"). While Black and Kraakman remain skeptical about the general applicability of this model, they concede that "[t]here may be exceptional cases, perhaps involving new, hard-to-value technology, where a larger amount of hidden value could be plausible." *Id.* at 553.

of time.[78] In fact, the whole business model of these firms depends on management's unique ability to generate returns from highly specialized resources. Similar issues affect declining corporations because their recovery potential (i.e., going-concern value) is largely dependent on management's ability to exploit opportunities that are not visible, and often unavailable, to outsiders.[79]

Lastly, investment specificity emerges as an additional feature that is shared by these corporate contexts. Specificity characterizes investments (or, more generally, assets) that, once deployed for a specific purpose, can be redeployed to alternative uses or users only at a loss of value.[80] Put another way, specific investments have limited exit.[81] Two features add to the specificity of financial and human capital investments in startups and declining corporations. First, the cost of acquiring information is high and difficult to recover because of the severe degree of information asymmetry affecting these corporate contexts.[82] Second, information is only valuable with respect to the specific corporation for which it was acquired, which implies that investors can only realize the upside of their investments as long as they maintain the relationship with that corporation.[83]

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78. *See, e.g.*, Allen N. Berger & Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 J. BANKING & FIN. 613, 614, 616 (1998) (discussing "informational opacity" in startups); Jeffrey J. Trester, *Venture Capital Contracting Under Asymmetric Information*, 22 J. BANKING & FIN. 675 (1998) (suggesting that startups' high level of asymmetric information can explain why preferred shares, rather than common equity, is the most frequent form of financing in venture capital investments).

79. The issue with declining corporations is understanding whether decline is reversible, which is likely dependent upon information that is available only to the management. For example, in 1982, after Harley-Davidson reported a loss of $30 million, many analysts pointed to the irreversibility of the company's decline. A new management team, however, was able to reverse this trend, devising "a strategy built around an [sic] loyal customer base and an iconic brand," causing Harley to rebound to profitability. *See* Damodaran, *supra* note 67, at 27.

80. The standard reference is to the studies of Oliver Williamson. *See, e.g.*, WILLIAMSON, *supra* note 43, at 55.

81. *See supra* note 17.

82. *See* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 240 (1979) (observing that set-up costs can be recouped only as long as the relationship in which they were incurred is maintained).

83. *Id.* It is also worth observing here that situations involving specialized investment capital are commonly "symmetrical." This means that, for the counterparty of a specialized investor (in this case, startups and declining corporations), "the cost of supply from unspecialized capital is presumably great." *See id.*

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3. Non-Common Equity (NCE) Investors as Quasi-Residual Claimants

Low net worth, asset volatility, severe asymmetric information, and investment specificity combine to turn NCE investors into "quasi-residual claimants," who are sensitive to any management actions and thus exposed to severe contractual incompleteness issues, despite holding only fixed claims against the corporation.[84] This is partially acknowledged by more recent corporate scholarship, which suggests that NCE investors employ complex agreements[85] to address the more severe contracting problems they face in these contexts.[86] Because of this particular sensitivity to management actions, and the attendant risks, investors in startups and declining corporations generally tend to be more informed and sophisticated parties, such as venture capitalists, banks, private equity funds, or hedge funds.[87] Unlike less-sophisticated investors, these parties have both the economic resources and expertise to bargain for the right

84. Option theory is useful to better illustrate the concept of quasi-residual claimants. Viewed through this prism, equity is understood as a call option over corporate assets, whose strike price is represented by the face value of the firm's claims that are senior to equity (i.e., NCE claims). *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973). The common shareholders are thus residual claimants in the sense that they are entitled to claim the difference between asset value and face value of the NCE claims at the option's maturity date. On such date, if the firm's assets are worth more than the NCE claims (the option is "in the money"), the shareholders will exercise their option; otherwise (if the option is "out of the money"), they will let the option expire. *See* GILSON & BLACK, *supra* note 61, at 233. This implies that the NCE investors are entitled to all the cash flows generated by the assets until their claims are repaid in full. In this sense, as long as the face value of NCE claims is below asset value, the NCE investors are quasi-residual claimants. This paradigm perfectly describes investors in startups and declining corporations where the shareholders' call option is generally out of the money.

85. *See* Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 91 (2000) (stating that complex agreements have "many terms describing the obligations of parties across alternative future states of the world; these terms . . . provide for highly variable rewards for desired behavior and penalties for undesired behavior; and these rewards and penalties . . . bear a complex mathematical relationship to the value of the benefits produced by the different kinds of behavior").

86. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, Essay, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006) (discussing creditor contracts in declining corporations); Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L.Q. 1005, 1007–11 (1994) (empirically documenting an increase in the number of restrictive covenants and veto provisions in contracts of creditors of distressed corporations); Steven N. Kaplan et al., *How Do Legal Differences and Experience Affect Financial Contracts?*, 16 J. FIN. INTERMEDIATION 273, 306 (2007) (suggesting that sophistication variables in venture capital contracts consistently have significant explanatory power).

87. *See, e.g.*, Baird & Henderson, *supra* note 28, at 1328 (observing that venture capital contracts are "heavily negotiated by informed and sophisticated parties"); M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1563 (2007) ("[S]ophisticated investors, such as banks, insurance companies, hedge funds, and bondholders . . . are specialist, repeat players in workouts or distressed investing.").

incentive schemes[88] and to supplement such schemes with extremely complex allocations of specific control rights.[89]

However, this view assumes that the issue is simply that NCE investors in startups and declining corporations are concerned with a larger set of possible management actions, such that complex contracting may effectively protect the investors' rights. Yet even complex contracting may be inadequate in such corporate contexts. For one thing, the contract might fail to serve as an effective monitoring mechanism because "external monitoring"—monitoring as provided for by contractual provisions, such as informational covenants that set regular reporting requirements[90]—can at best result in the ex post acquisition of information concerning management actions.[91] Such mechanisms are inferior to "internal monitoring" mechanisms—those exercised within the corporate organization—which lead to the acquisition of information on management actions as they occur. Moreover, external monitoring cannot provide access to soft information,[92] which is unverifiable to outsiders and, therefore, cannot be captured by specific contractual provisions. To some extent these limits arise in any corporate environment, but they are exacerbated where information asymmetry between management and outsiders is significant and potentially long-lasting.

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88. For example, the empirical evidence shows that both venture capitalists and other specialist providers of NCE capital often play a significant role in setting management compensation policies in startups and declining corporations respectively. *See* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 60–62 (Michael J. Whincop ed., 2001); Henderson, *supra* note 87, at 1617; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 711 (1993).

89. *See* Baird & Henderson, *supra* note 28, at 1328–29. As Baird and Henderson aptly observed, a firm's "formation"—the startup stage—and "death"—financial distress—raise similar crucial issues, which make the allocation of control rights pivotal. *Id.* at 1329 & n.91. This part analyzes why this is the case and why such situations may demand that property rights conferring residual rights of control be shifted from shareholders to NCE investors.

90. *See* TIROLE, *supra* note 16, at 86 (describing informational covenants).

91. *See* Henderson, *supra* note 87, at 1559 ("The only information available to most investors is the highly ritualized and often opaque information that comes through official, regulated disclosures and public statements, which do not provide sufficient information to monitor key aspects of firm behavior."). Henderson argues that monitoring costs decrease once a corporation enters a formal Chapter 11 bankruptcy procedure "because of the powers [NCE investors] wield by statute, regulation, and contract, as well as through the more robust judicial oversight by the bankruptcy court." *Id.* at 1563. In private workouts, however, NCE investors lack both these powers and the benefit of judicial oversight.

92. "Hard information" is "information that can be verified by the investors once disclosed by the issuer" (i.e., the corporation). *See* TIROLE, *supra* note 16, at 249. In contrast, "soft information" is information that cannot be easily verified by the investors even when it is disclosed. *Id.* at 250.

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Additionally, the contract might be an inadequate instrument to ensure effective enforcement of even the bargained-for rights of NCE investors in startups and declining corporations. First, courts are less likely to be able to verify information where corporate value is hidden. Consider, for example, a contractual provision granting investors the right to sell the corporation at a "fair price" upon some set of triggering events. The court may find it extremely difficult to discern whether a given price is "fair" when market value cannot provide a viable benchmark.[93] Second, self-enforcing contractual provisions that can operate without court intervention may become ineffectual where investments are highly specific. As noted above, specificity limits the availability of exit (e.g., withdrawal rights).[94] Consequently, it also limits an investor's ability to employ the *threat* of exit, which is one of the most common means of making contractual provisions self-enforcing.[95] Imagine a contract providing for a right of withdrawal upon the management's violation of a no-change-of-business-line covenant.[96] Because the threat of exit may ring hollow when investments are specific, the related covenant becomes toothless.

This parallels the contracting problems faced by shareholders. On the one hand, the defining features of NCE investments in startups and declining corporations virtually require that NCE investors, similar to shareholders,[97] control any management action in order to realize the upside of their claims (i.e., extract hidden corporate value). On the other hand, these same features make the contract alone an inadequate instrument to provide them with this kind of control.[98]

As noted in Part I.A.2, corporate law's response to shareholder contracting problems is to provide the added safeguards of internal governance mechanisms—the shareholder franchise and fiduciary

93. *See supra* note 77 (describing the distinguishing features of the hidden value model of the corporation).

94. *See supra* text accompanying notes 80–83 (discussing asset specifity).

95. *See, e.g.*, TIROLE, *supra* note 16, at 31–32 (arguing that exit rights are a means to make the claims of noncontrolling stakeholders (i.e., NCE investors) insensitive to the actions of shareholders (i.e., management)); Sepe, *supra* note 51, at 365–66 (describing the self-enforcing function of the threat of exit in creditors' contracts).

96. Covenants earmarking the loan for specific purposes or preventing investments in new lines of business are designed to constrain the risk of ex post increases in corporate risk. *See* TIROLE, *supra* note 16, at 85.

97. *See* Macey, *supra* note 45, at 36 ("[S]hareholders must retain positive control over the actions of the firm in order to realize the full potential value of their shares.").

98. *See supra* text accompanying notes 45–46 (discussing the contractual incompleteness issues affecting shareholders).

http://openscholarship.wustl.edu/law_lawreview/vol91/iss2/2

protection.[99] These mechanisms grant shareholders, as beneficiaries of board action, residual control over the corporation, consisting in the power to take adaptive action. In economic terms, we can say that the allocation of residual control to the shareholders serves to satisfy their "participation constraint,"[100] making the shareholders' corporate contract one worth undertaking.

Because NCE investors in startups and declining corporations are confronted with analogous contracting problems, a rational argument exists for assuming that they would seek similarly added safeguards to make their investments viable.[101] Thus one can predict that, lacking legal entitlement to such institutional protections, these investors would privately bargain for them. In practice, NCE investors in startups and declining corporations do just that. As the next Part will explain, NCE investors regularly appoint "constituency directors" who are expected to act as their representatives on the board and exercise residual control over the corporation on their behalves.

C. The Rise of Constituency Directors

A working definition of "constituency directors" (also known as "representative directors" or "designated directors") includes directors whose election to the board is traceable to a well-identified corporate constituency (i.e., the "designating investor" or "sponsor"). As discussed below, examples include directors designated by venture capitalists, preferred shareholders, creditors, labor unions, and even the federal government.[102]

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99. *See supra* text accompanying notes 51–56 (discussing internal governance mechanisms).

100. The participation constraint, or "individual rationality constraint," is defined as a property of optimal agency contracts which is satisfied when the contract leaves all participants at least as well off as they would have been if they had not participated. *See* SALANIÉ, *supra* note 50, at 122.

101. *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1082 (2003) (arguing that when uncertainty is extreme, the contractual structure needs to compensate for this uncertainty "by means of a governance structure: creating a process that will determine the response to an unexpected event"); Williamson, *Corporate Governance*, *supra* note 10, at 1205–06 (suggesting that non-shareholders investing in specific assets may need board representation, in addition to specialized contractual structures, in order to protect their interests).

102. *See supra* note 4 (explaining why the discussion of constituency directors who are appointed by the common shareholders remains outside the scope of this Article).

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1. Venture Capital Contracts

Because of their intrinsic complexities, venture capital investments in startups are often described as an example of financing that obliterates the difference between debt and equity.[103] In practice, however, during the earlier, and riskier, stages of a venture, venture capitalists almost always choose debt-like attributes by investing in preferred stock with substantial liquidation preferences.[104] To protect their (debt-like) cash flow rights, venture capitalists routinely secure board representation in addition to enhanced control rights.[105] In their study of startups, Steven Kaplan and Per Strömberg report that venture capitalist investors obtain a seat on the board of directors in over 40 percent of startups and board control in about 25 percent.[106] However, as observed by Jesse Fried and Mira Ganor, this likely underrepresents the frequency with which venture capitalists acquire board control.[107] In many cases, seemingly independent startup directors "are chosen by the [venture capitalists] . . . and have—or can expect to have—long-term professional and business ties with the [venture capitalists]."[108] This reflects the fact that a constituency director need not

103. *See* Baird & Rasmussen, *supra* note 86, at 1217.

104. *See, e.g.*, METRICK & YASUDA, *supra* note 12, at 163; *see also* Richard A. Mann et al., *Starting From Scratch: A Lawyer's Guide to Representing a Start-up Company*, 56 ARK. L. REV. 773 app. at 858–60 (2004) (observing that the liquidation rights of VC investors can be equal to six times the original investment or higher). Although the preferred stock agreements of venture capitalists regularly include conversion options, conversion is typically triggered by events occurring in later development stages, such as the achievement of performance targets or a successful initial public offering (IPO). *See* George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 317 (2001) (reviewing PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (1999)).

105. *See* Gilson, *supra* note 101, at 1073–74, 1082–83.

106. *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 287–90 (2003) (investigating a sample of 119 startups). Further studies reveal that the extent of board control by venture capitalists increases with each round of funding. *See* Ibrahim, *supra* note 70, at 1193. Additionally, board control by venture capitalists does not necessarily decline after a portfolio company becomes publicly traded. *See* Moscow, *supra* note 4, at 14–15. Instead, in a significant number of venture-financed IPOs, VC investors continue to hold directorship until their investment in the firm is entirely liquidated. *See* Joseph Hinsey, *The Constituency Director*, THE HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 14, 2008, 3:26 PM), http://blogs.law.harvard.edu/corpgov/2008/01/14/the-constituency-director.

107. *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 988–89 (2006).

108. *Id.* at 988–89. *See also* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. Rev. 315, 320 (2005) (observing that "in the event of conflict between the venture capitalist and the entrepreneur . . . outside directors may have a natural inclination to side with the venture capitalist"); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L.REV. 891, 921 (2002) (arguing that outside directors are "highly susceptible to the influence of the VC") (italics omitted).

be defined explicitly as such, but rather may be the result of a director's affiliation, whether professional or personal, with the designating investor.

2. Creditor, Union, and Government Contracts

The appointment of constituency directors has the most variegated implications in the context of the declining corporation. In recent years, corporate law scholars have paid increasing attention to the active role of creditors in corporate governance, especially in troubled corporations.[109] While these scholars rarely explicitly label creditor-appointed board members as constituency directors, they observe that taking one or more board seats is one of the preferential ways through which creditors exercise substantial control over these corporations.[110]

Constituency directors in declining corporations may also be nominated by unions. Despite the absence of a mandate for workforce codetermination of board members in the United States,[111] the past thirty years have seen American unions obtain board seats in exchange for wage concessions and other union givebacks to financially troubled corporations.[112] Recent research suggests that this trend continues,[113] especially in sectors where unions have had historic success at securing board seats, such as the automotive, trucking, airlines, and steel

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109. *See, e.g.*, Baird & Rasmussen, *supra* note 86 (focusing on private debt); Gilson & Vetsuypens, *supra* note 86; Henderson, *supra* note 87, at 1563–69 (discussing creditor governance in reorganizing firms in both Chapter 11 and private procedures).

110. *See, e.g.*, Baird & Rasmussen, *supra* note 86, at 1217; Henderson, *supra* note 87, at 1581–82; Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 409–11 (1997) (finding that vulture investors take board positions in about thirty percent of the cases and that, because of the lack of available data, this figure is likely to underestimate effective board involvement by such investors).

111. These mechanisms are instead common in some European countries, most notably Germany. *See, e.g.*, Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret M. Blair & Mark J. Roe eds., 1999).

112. *See, e.g.*, Eileen Appelbaum & Larry W. Hunter, *Union Participation in Strategic Decisions of Corporations*, *in* EMERGING LABOR MARKET INSTITUTIONS FOR THE TWENTY-FIRST CENTURY 265, 280–84 (Richard B. Freeman et al. eds., 2005); Larry W. Hunter, *Can Strategic Participation Be Institutionalized? Union Representation on American Corporate Boards*, 51 INDUS. & LAB. REL. REV. 557 (1998). The most well-known example is the appointment of Douglas Fraser, the then-president of United Auto Workers, to the board of Chrysler following the concessions associated with the company's near collapse in 1980. *See* Douglas A. Fraser, *Worker Participation in Corporate Government: The U.A.W.-Chrysler Experience*, 58 CHI.-KENT L. REV. 949 (1982). It is worth emphasizing that, from the hidden value perspective adopted by this Article, unions' wage concessions to declining corporations are qualitatively equivalent to the financial concessions of lenders specialized in distressed investments. Indeed, both these constituencies make a bet on a declining corporation's hidden opportunities for economic recovery. *See supra* note 79 and accompanying text.

113. *See* Appelbaum & Hunter, *supra* note 112, at 281.

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industries.[114] The appointment of a representative of the United Auto Workers union to the boards of directors of the "new" General Motors ("GM")[115] and Chrysler[116] are only the most recent manifestations of this trend.[117]

Yet the most innovative use of constituency directors in declining corporations has emerged in connection with the Troubled Asset Relief Program (TARP)[118] launched by the U.S. government during the financial

114. *See* Robert B. McKersie, *Union Nominated Directors: A New Voice in Corporate Governance*, *in* NEGOTIATIONS AND CHANGE: FROM THE WORKPLACE TO SOCIETY 223 (Thomas A. Kochan & David B. Lipsky eds., 2003). Consistent with the use of constituency directors by other types of NCE investors, union board representation does not necessarily require active union membership. Although union officials have held directorships, other common approaches involve the appointment of retired union officials and "union-friendly" outsiders, such as union consultants and lawyers. Appelbaum & Hunter, *supra* note 112, at 281–82.

115. *See* Press Release, United Automobile Workers, VEBA Trustees Name Stephen J. Girsky to Board of General Motors (June 18, 2009), *available at* http://www.uaw.org/articles/veba-trustees-name-stephen-j-girsky-board-general-motors.

116. *See* Press Release, Chrysler Group, New Appointments to the Chrysler Group Board of Directors (June 14, 2012), *available at* http://www.chryslergroupllc.com/Investor/PressReleases/ChryslerDocuments/ChryslerGroupLLC_NewAppointmentsBoD_2012June14.pdf.

117. The UAW obtained board representation in exchange for the concessions made during the 2009 restructuring of both GM and Chrysler, which included eased demands on both wages and job security. Most importantly, the UAW agreed to waive the cash payments GM and Chrysler owed to it as trustee of each company's VEBA fund. *See* Micheline Maynard, *Union Takes Rare Front Seat in Chrysler Deal*, N.Y. TIMES, May 2, 2009, at A1. A VEBA—Voluntary Employee Benefit Association—is a trust that holds funds to meet the cost of health and welfare benefits, with funds being provided by periodic employer contributions. *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 490 (9th ed. 2007). In 2007, both GM and Chrysler reached an agreement with the UAW to transfer their employees' health benefits plans to two newly founded VEBA trusts. With this transfer, the UAW assumed all responsibilities for health care inflation risk in exchange for periodic cash contributions by GM and Chrysler. *See* Ellen O'Brien, *What Do the New Auto Industry VEBAs Mean for Current and Future Retirees?*, AARP 1 (Mar. 2008), *available at* http://assets.aarp.org/rgcenter/econ/i4_veba.pdf. Thus, when in 2009 both GM and Chrysler went into Chapter 11, the UAW, backed by the U.S. government, received preferential treatment as each company's largest creditor. *See* James Sherk & Todd Zywicki, Opinion, *Sherk and Zywicki: Obama's United Auto Workers Bailout*, WALL ST. J. (June 13, 2012, 10:07 PM), http://online.wsj.com/article/SB10001424052702303768104577462650268680454.html (arguing that the UAW's preferential treatment violated the distribution priority rules of U.S. bankruptcy law). Among other benefits, the UAW received a consistent share of the stock of the "new" GM and Chrysler as a guarantee of the companies' future fulfillment of VEBA obligations and the right to appoint a union representative to the board of each company. *See* Maynard, *supra*; David Welch, *UAW Sends Girsky to GM's Board*, BLOOMBERG BUSINESSWEEK (June 18, 2009), http://www.businessweek.com/autos/autobeat/archives/2009/06/uaw_sends_girsk.html.

118. TARP was established within the legal framework of the Emergency Economic Stabilization Act, which Congress enacted in October 2008 in the effort to contain the systemic effects of the financial crisis. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of 12 U.S.C.). Under TARP, the U.S. Department of Treasury was authorized to purchase toxic assets (i.e., mortgages, mortgage-backed securities, and other structured products) for an amount of almost $700 billion through the establishment of multiple specific programs. *See About TARP*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/about-tarp/Pages/what-did-tarp-do.aspx (last updated Dec. 12, 2013, 10:51 AM).

crisis of 2007–2009 to rescue troubled financial institutions.[119] Under the Capital Purchase Program (CPP), which was the first and largest of the multiple initiatives conducted within the TARP framework, the U.S. Department of Treasury purchased $205 billion in senior preferred stock ("Preferred") from 707 troubled banks.[120] While the Preferred were nonvoting, in a little-noticed part the Treasury's term sheet provided that "[i]f dividends on the Preferred are not paid in full for six dividend periods, whether or not consecutive, the Preferred will have the right to elect 2 directors."[121] A similar provision appeared in the terms and conditions of the Systemically Significant Failing Institutions Program (SSFIP)—the initial program the Treasury used to provide liquidity support to insurance giant AIG.[122] Even less-noticed was the fact that the Treasury *did* exercise its rights to elect board members under both the CPP and the SSFIP. In April 2010, after AIG had missed multiple TARP dividend payments, the Treasury exercised its right to appoint two directors to the AIG board.[123] Similarly, in July 2011, the Treasury announced that it had, for the first time, elected directors to the boards of two recipients of CPP funds that had breached the six-missed-dividend waiver.[124] By October 2012, the number of Treasury-appointed directors had increased to twenty-four across fourteen CPP institutions.[125]

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119. Although less apparent on the surface, this Article's hidden value theory of NCE investments also applies to the U.S. government's interventions in troubled financial corporations. Indeed, by preserving the hidden opportunities for economic recovery of these corporations, the government prevents individual failures that may lead to macroeconomic shocks. Hence, the extraction of hidden corporate value in these circumstances takes an indirect form, consisting of the government's avoidance of the enormous expenses associated to macroeconomic shocks.

120. *See Capital Purchase Program*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/cap/Pages/overview.aspx (last updated Dec. 12, 2013, 11:36 AM).

121. *See* Press Release, U.S. Dep't of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, Excluding S Corps and Mutual Organizations): Preferred Securities 4, http://www.treasury.gov/press-center/press-releases/Documents/term%20sheet%20%20private%20c%20corporations.pdf (last visited Dec. 23, 2013).

122. *See* SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, AIG REMAINS IN TARP AS TARP'S LARGEST INVESTMENT, Q. REP.TO CONGRESS 6 (July 25, 2012), http://www.sigtarp.gov/Audit%20Reports/AIG_Remains_in_TARP_Mini_Book.pdf (last visited Dec. 23, 2013).

123. *See* AIG—Press Release, *supra* note 25.

124. *See* Press Release, U.S. Dep't of the Treasury, Treasury Elects Directors to CPP Banks' Boards of Directors (July 19, 2011), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1249.aspx.

125. *See* TREASURY REPORT TO CONGRESS—OCT. 2012, *supra* note 25, at 9.

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3. *Constituency Directors as Complementary Goods*

The above discussion of constituency directors suggests that they are a customary feature of NCE investments in startups and declining corporations. Yet a unified analysis of constituency directors remains conspicuously absent in the corporate law scholarship.[126] At best, legal scholars have mentioned that board representation *may* be secured in venture capitalist contracts or creditor contracts upon distress.

This is a reductive account for several reasons. First, it omits consideration of both union-nominated directors and government-nominated directors, whose governance implications are crucial in difficult economic times like the present.

Second, this account only conceives of constituency directors as a *substitute good*[127]—a means to lower a NCE investor's monitoring costs, and therefore a corporation's cost of capital, when more ordinary means such as tangible assets and positive cash flows are not available for that purpose.[128] While this explanation may be plausible in some cases,[129] in

126. The literature on constituency directors is mostly confined to practitioners' commentary and a few blog postings. *See, e.g.*, Robert Little & Chris Babcock, *Walking the High Wire: Guidelines for Board of Director Designees of Private Equity Funds, Activist Stockholders and Other Investors*, 44 SEC. REG. & L. REP. 2245 (2012); David M. Morris et al., *Designated Directors and Designating Investors: Early Planning Is Key*, 16 CORP. GOVERNANCE ADVISOR, May–June 2008, at 5; Moscow, *supra* note 4; E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761 (2008); Terence Woolf, Note, *The Venture Capitalist's Corporate Opportunity Problem*, 2001 COLUM. BUS. L. REV. 473 (discussing divided loyalty issues arising when constituency directors hold dual directorship); Stephen Bainbridge, *Constituency Directors*, PROFESSORBAINBRIDGE.COM (Mar. 29, 2011, 11:27 AM), http://www.professorbainbridge.com/professorbainbridgecom/2011/03/constituency-directors.html; Hinsey, *supra* note 106; *see also* R.P. Austin, *Representatives and Fiduciary Responsibilities—Notes on Nominee Directorships and Life Arrangements*, *7* BOND L. REV., June 1995, at 19 (providing a legal analysis of constituency directors in commonwealth countries).

127. N. GREGORY MANKIW, PRINCIPLE OF ECONOMICS 70 (2008).

128. *See, e.g.*, Triantis, *supra* note 104, at 314.

129. For example, this may be the case in private debt where the debtor is not a declining corporation. Recent studies observe that in thirty percent of private debt, the appointment of bank-affiliated directors is a regular contractual feature from the outset of the parties' relationship. *See, e.g.*, Randall S. Kroszner & Philip E. Strahan, *Bankers on Boards: Monitoring, Conflicts of Interest, and Lender Liability*, 62 J. FIN. ECON. 415, 416 (2001). This is consistent with the idea that investment specificity is one of the reasons underlying the use of constituency directors by NCE investors, since the bank-debtor relationship tends to develop specificity features over time. *See* Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 117, 143–44 (2009) (suggesting that private debt involves relationship-specific investments). But when the debtor is not a declining corporation (or a startup), asset specificity is not necessarily associated with the other distinguished features (e.g., low net worth) that make the appointment of a constituency director necessary to fully protect the investors' interests. In these contexts, it is likely that bank-appointed directors may serve as mere substitute goods. *See id.* at 139

startups and declining corporations, monitoring problems are likely to affect an investment's feasibility, rather than just investment costs. Indeed, as explained above, in these contexts the value of monitoring increases while the ability of a contract to supply such monitoring effectively decreases.[130]

Additionally, by framing the role of constituency directors as providing a mere informational function, the above account fails to consider that board members do not just process information, but also act on that information. For example, the control levers obtained by venture capitalists and creditors through board representation regularly carry with them the power to replace incumbent management and initiate fundamental transactions.[131] Therefore, this Article argues that constituency directors are in most cases a *complementary* rather than a *substitute* good[132]—meaning that a constituency director's ability to access private information and exercise adaptive decision-making are necessary to make NCE investments viable where they might otherwise not be.

Finally, by failing to fully take into account the role of constituency directors, current scholarly discussions also fail to consider related normative issues. These issues arise out of existing rules of corporate law under which the entitlement to residual control rights is a non-negotiable shareholder prerogative. As the next Part will explain, this limitation jeopardizes the effective use of constituency directors, harming not just NCE investors but also shareholders and society as a whole.

II. THE LAW AND ECONOMICS OF CONSTITUENCY DIRECTORS

This Part describes the current inefficiencies inherent to the appointment of constituency directors. These inefficiencies are the negative by-product of a pillar of corporate law: the principle that *all* directors owe undivided loyalty to the corporation and its shareholders, regardless of whether they have been designated by the shareholders or another constituency. Hence, constituency directors may be liable for breach of fiduciary duty if they act as the true representatives of their designating investors. But current rules of corporate law not only make things legally difficult for NCE investors, they interfere with welfare

(arguing that the informational benefits arising from having a banker on the board economize "on contracting and information production costs, to the benefit of both borrower and lender").

130. *See supra* text accompanying notes 90–92.

131. *See* Baird & Rasmussen, *supra* note 86, at 1233; Fried & Ganor, *supra* note 107, at 987; Gilson, *supra* note 101, at 1082.

132. MANKIW, *supra* note 127, at 70.

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maximization. Indeed, failing to recognize that constituency directors serve to make NCE investments viable where they might otherwise not be, these rules may reduce a corporation's access to NCE capital and, ultimately, lead profitable investments to go unfunded.

A. Corporate Fiduciary Law and Its Consequences

An analysis of the current state of the law as concerns constituency directors exposes the way the law fails to capture the fundamental role performed by constituency directors in the corporate system.

1. The Undivided Loyalty Principle

NCE providers plainly expect their appointed constituency directors to act as their representatives on the board. This expectation applies to both the monitoring and enforcement functions performed by constituency directors. As a monitoring device, constituency directors are expected to serve as their sponsors' eyes and ears on the board,[133] transmitting information about boardroom discussions and activity as well as any other non-public information concerning the company and its performance.[134]

In addition, as an enforcement device, constituency directors are expected *to act* as their sponsors' "advocates" within the firm,[135] providing adaptive responses to unanticipated events. Such advocacy may involve different levels of board activity, from giving voice to the views of designating investors in the day-to-day management of the firm to strategic decision-making in response to both vertical and horizontal agency problems.

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133. *See* Veasey & Di Guglielmo, *supra* note 126, at 774; Charles M. Nathan et al., *Maintaining Board Confidentiality*, THE HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 23, 2010, 2:12 PM), http://blogs.law.harvard.edu/corpgov/2010/01/23/maintaining-board-confidentiality (stating that constituency directors view their role on the board as necessarily involving an obligation to keep their sponsors informed about company matters).

134. Nathan et al., *supra* note 133 (suggesting that constituency directors' access to "material board information", in addition to "material company information", raises novel confidentiality issues that interested parties may find difficult to address effectively).

135. There is a robust economic literature on the informational and organizational value of advocacy systems, which exploit the benefits arising from the competing interaction of individuals who are appointed to be advocates of specific causes. *See* Mathias Dewatripont & Jean Tirole, *Advocates*, 107 J. POL. ECON. 1 (1999) (providing a formal discussion about the use of advocacy systems in various organizational contexts); *see also* Sepe, *supra* note 51, at 372–75, 394–404 (proposing to amend prudential bank regulation to incentivize the adoption of banks' governance models built around a system of advocacy).

It is worth emphasizing, however, that when NCE investors are quasi-residual claimants, their interests perfectly converge with those of the shareholders in terms of controlling the vertical problem of effort.[136] Thus, it is the control of horizontal agency problems—i.e., management's risk choices[137]—that is at the core of a constituency director's strategic decision-making. This means that in situations involving a conflict of interest between the designating investors and the shareholders, the role served by constituency directors essentially entails taking actions that are antithetical to the interests of the shareholders.[138]

However, these expectations of NCE investors about the role of their board representatives are in direct conflict with a director's obligations under existing corporate fiduciary law. Indeed, a fundamental principle of this law—embraced by the Supreme Court as early as the nineteenth century[139] and reiterated ever since by Delaware courts—is that "directors . . . have 'the legal responsibility to manage the business of a corporation

136. To some extent, NCE investors always benefit from increased managerial effort because higher effort increases the likelihood of successful corporate performance and, therefore, the likelihood that the corporation will be able to meet its fixed obligations. *See supra* note 65 and accompanying text; *see also* Triantis & Daniels, *supra* note 38, at 1078. However, as shown by Figure 1 above, the magnitude of this benefit varies greatly depending on whether a corporation's net-worth is sufficient to insulate NCE investors from the detrimental effects of low managerial effort on asset value. *See supra* Part I.B.1. When this is the case (i.e., a company has high net worth), NCE investors will be less sensitive to managerial effort. In contrast, when a company has low net worth, NCE investors will be highly sensitive to managerial effort. This explains why in startups and declining corporations there is perfect convergence between NCE investors and shareholders as concerns the problem of managerial effort. The notable exception is the fledgling startup, where shareholder-founders directly manage the venture and, therefore, may have incentives to exert lower effort to the detriment of NCE investors.

137. *See supra* notes 40–42 and accompanying text.

138. *See* Baird & Henderson, *supra* note 28, at 1320 (suggesting that creditors' ultimate aim in bargaining for board control is "to put in place directors who will not do what the shareholders want"). It is important to note that the ability of constituency directors to influence corporate decisions will vary with the level of board control they enjoy—as determined by both the ratio of constituency to non-constituency directors and the specific rules governing board voting. It is self-evident that constituency directors can unilaterally determine decisional outcomes when they hold the majority of board seats. But a majority of constituency directors is not strictly required to gain decisive influence over corporate decision-making. In cases of supermajority voting provisions, constituency directors may have a substantial impact on decisional outcomes even if they comprise less than a majority of the board. *See* Veasey & Di Guglielmo, *supra* note 126, at 762 (providing a practical example of how, under a supermajority voting rule, constituency directors can determine decisional outcomes). In fact, because on many board issues there is a tendency to move on unanimity, even a single constituency director may have a role in influencing board decisions. *See* McKersie, *supra* note 114, at 239.

139. *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."); Dodge v. Woolsey, 59 U.S. (18 How.) 331, 341 (1855) (establishing that courts have authority "to restrain those who administer [corporations] from doing acts . . . which might result in lessening the dividends of stockholders, or the value of their shares").

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for the benefit of its shareholders owners.' Accordingly, fiduciary duties are imposed upon the directors to regulate their conduct when they perform *that* function."[140] The immediate implication of this functional approach to corporate fiduciary duty is that, once a director has been elected to a corporation's board, she owes undivided loyalty to the shareholders of that corporation[141]—regardless of how she was nominated or by whom.[142]

In practice, this means that constituency directors may be held liable for breach of fiduciary duty when behaving consistently with their sponsors' expectations. When it comes to fulfilling their function as monitors, constituency directors are confronted with the burden of the duty of confidentiality—a corollary of the duty of loyalty that requires directors not to disclose confidential company information to third parties.[143] While

140. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (quoting Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998)).

141. Delaware courts have articulated the requirement of undivided loyalty sometimes as owed "to the corporation" and sometimes as owed to "the corporation and its shareholders." *See* Veasey & Di Guglielmo, *supra* note 126, at 764 & n.8. However, the operation of this requirement, in both academia and judicial opinions, has consistently identified the interests of the shareholders as proxy for the interest of the corporation. *See* Chen & Hanson, *supra* note 57, at 46–52 (describing the largely majoritarian scholarly view that pursuing the shareholder interest is the best way to pursue the corporation's interest).

142. *See* Deutsch v. Cogan, No. 8808, 1989 WL 34983, at *4 (Del. Ch. April 11, 1989)("Under Delaware law, a director owes an uncompromising duty of loyalty to the shareholders of the corporation."); Phillips v. Insituform of N. Am., Inc., No. 9173, 1987 WL 16285, 13 DEL. J. CORP. L. 774, at *790 (Del. Ch. Aug. 27, 1987) ("[T]he law demands of directors . . . fidelity to the corporation and all of its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them . . . ."); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("There is no 'safe harbor' for such divided loyalties in Delaware."); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (providing the classic statement of the duty of undivided loyalty, which reads as follows: "[t]he rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."); *see also* ABA SECTION OF BUS. LAW, CORPORATE DIRECTOR'S GUIDEBOOK (2d ed. 1994), *reprinted in* 49 BUS. LAW. 1243, 1250 (1994) ("A director should exercise independent judgment for the overall benefit of the corporation and all of its shareholders, even if elected at the request of a controlling shareholder, a union, a creditor, or an institutional shareholder or pursuant to contractual rights.").

143. *See, e.g.*, Venoco, Inc. v. Eson, No. 19506-NC, 2002 Del. Ch. LEXIS 65, at *20 (Del. Ch. June 6, 2002) ("It is well-settled that directors 'are not permitted to use their position of trust and confidence to further their private interests' because the law 'requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest.'") (quoting *Guth*, 5 A.2d at 510); *Malone*, 722 A.2d at 12 ("The directors' duty to disclose all available material information in connection with a request for shareholder action must be balanced against its concomitant duty to protect the corporate enterprise, in particular, by keeping certain financial information confidential."); *see also* COMM. ON CORPORATE LAWS, ABA SECTION OF BUS. LAW, CORPORATE DIRECTOR'S GUIDEBOOK (5th ed. 2007), *reprinted in* 62 BUS. LAW. 1479, 1500 (2007) ("A director must keep confidential all matters involving the corporation that have not been disclosed to the public.").

case law on the duty of confidentiality is sparse,[144] commentators agree that constituency directors navigate in perilous waters in transmitting information to their sponsors in circumstances involving a conflict of interest between the sponsor and the corporation's shareholders.[145]

More importantly, the duty of undivided loyalty to shareholders may prevent constituency directors from taking actions to the exclusive benefit of the designating investors. Traditionally, Delaware courts have navigated around this duty by applying the business judgment rule, despite the fact that constituency directors clearly do not meet the standard requirements for application of the rule—independence and disinterested judgment.[146] The reason for such an approach was to avoid grappling with the application of fiduciary duty rules to constituency directors. However, beginning with the 2009 groundbreaking decision in *In re Trados Inc. Shareholder Litigation*,[147] Delaware courts have shown no such reticence and have begun strictly enforcing the duty of undivided loyalty, virtually depriving constituency directors of any effective role.

2. *The* Trados *Decision*

Trados involved an allegation of a breach of fiduciary duty brought by a common shareholder who claimed that the board, dominated by preferred shareholder designees,[148] favored its own interests and the

144. *See* Cyril Moscow, *Director Confidentiality*, 74 LAW & CONTEMP. PROBS. 197, 200–02 (2011). The case law concerning the duty of confidentiality has traditionally framed such a duty as instrumental to prevent trading based on inside information and competitive harm rather than to deal with informational issues arising among corporate constituencies. *See* Nathan et al., *supra* note 133; Morris et al., *supra* note 126, at 5. More recent case law, however, has applied the duty of confidentiality to sanction the conduct of investors' representatives. *See, e.g.*, Shocking Techs., Inc. v. Michael, No. 7164-VCN, 2012 BL 257554, at *10–11 (Del. Ch. Oct. 1, 2012) (director held liable for disclosing information to a potential investor); *Venoco*, 2002 Del. Ch. LEXIS 65, at *20–21 (directors held liable for breach of the duty of confidentiality in assisting their sponsor to prepare an unsolicited bid for the company); Agranoff v. Miller, 1999 WL 219650 (Del. Ch. Apr. 12, 1999) (director found liable for breach of fiduciary duty in disclosing material company information to her sponsor).

145. *See, e.g.*, Veasey & Di Guglielmo, *supra* note 126, at 773–74; Little & Babcock, *supra* note 126, at 2. *But see* Moscow, *supra* note 144, at 206–07 (suggesting that confidentiality agreements between the corporation and the designating investors are a sufficient instrument to protect constituency directors from liability for breach of the duty of confidentiality). Moscow, however, fails to consider that confidentiality agreements are plagued by the same contractual incompleteness issues that make the appointment of constituency directors necessary in the first place. This means that, in order to fully protect their sponsors' expectations, constituency directors might need to transmit information to their sponsors in unforeseeable situations. Hence, confidentiality agreements have at best limited utility in insulating such directors from liability for breach of the duty of confidentiality.

146. *See* Moscow, *supra* note 4, at 16.

147. No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

148. *Id.* at *1. Specifically, the preferred shareholder designees occupied four out of seven board seats. *Id.* Of the remaining three seats, two were occupied by top officers and one by an independent

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interests of the preferred shareholders at the expense of the common shareholders.[149] Trados Incorporated, the company at issue, was a venture-capital-backed company that faced serious financial difficulties after some years in business.[150] In response, the board hired a new CEO and, at the same time, began to explore a potential sale or merger of the company.[151] In spite of a promising performance improvement, the board approved a merger of the company less than a year after appointing the new management.[152] The preferred shareholders realized almost $52 million in liquidation proceeds from the merger.[153] The common shareholders received nothing.[154]

The court upheld the plaintiff's claim for purposes of denying the directors' motion to dismiss.[155] First, the court reasoned that the interests of the preferred shareholders diverged from the interests of the common shareholders in matters related to the merger.[156] Indeed, the preferred shareholders stood to make millions from the merger while the common shareholders would walk away empty-handed, notwithstanding the legitimate expectation that their participation in Trados could have some future value.[157] Based on this premise, the court framed the central issue in the case as concerning a director's duties when conflicts of interest arise between common and preferred shareholders. Reiterating prior case law about the contractual nature of preferred shareholders' rights, the court acknowledged that "the duty of the board, where discretionary judgment is to be exercised, [is] to prefer the interests of common stock . . . to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict."[158] In *Trados*, the preferred shareholders had no

director. *Id.* at *1–2.

149. *Id.* at *1–4.

150. *Id.* at *1–2.

151. *Id.* at *2–3.

152. *Id.* at *3–4.

153. *Id.* at *1. More precisely, the Trados merger yielded $60 million, which were allocated as follows: (i) $7.8 million went to top executives under a management incentive scheme that was designed to incentivize a merger of the company, (ii) the remaining $51.2 million went to the preferred shareholders under a liquidation preference provision in favor of the preferred that provided that a merger be deemed a liquidation event. *Id.* at *3.

154. *Id.*

155. *Id.* at *9.

156. *Id.* at *7.

157. *Id.*

158. *Id.* at *7 (quoting Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) (internal quotation marks omitted). In reiterating the case law on the nature of preferred shareholders rights, the court quotes Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986). *Id.* at *7 n.39. This case sets the modern standard of review of the preferred shareholders' corporate position vis-à-vis that of the common shareholders. In *Jedwab*, the court established that:

specific contractual right to force the merger.[159] Therefore, it was *possible* that the Trados directors had breached their duty of loyalty to the common shareholders.[160]

But the court's decisive argument to deny the defendant's motion to dismiss concerned the relationships between the board majority and the preferred shareholders. The court held, in essence, that because the majority of Trados directors "had an ownership or employment relationship with an entity that owned Trados preferred stock,"[161] they were to be held interested in the merger and therefore, subject to the strict entire fairness test, rather than the much more flexible business judgment rule. Even more importantly to the purpose of this discussion, the court's dicta indicate a perception that being a board designee of a particular constituency may be sufficient for a director to be incapable of exercising disinterested judgment.[162] Indeed, the court explicitly noted that "a lack of independence can be shown by pleading facts that support a reasonable inference that the director is beholden to a controlling person or 'so under their influence that their discretion would be sterilized.'"[163] In this respect,

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> [W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards.

Jedwab, 509 A.2d at 594. Thus, *prima facie*, *Jedwab* introduces an exception to the general rule that the preferred shareholders' rights are contractual in nature. *See also In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562, at *14 (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993) (holding that directors are obligated to treat the preferred fairly when they share a right with the common). In practice, however, the room for this exception has been largely limited by subsequent Delaware decisions, which have reemphasized the general rule that preferred rights are contractual in nature. *See* Blue Chip Capital Fund II Ltd. P'ship v. Tubergen, 906 A.2d 827, 833 (Del. Ch. 2006) (expressing the view that the rights of preferred shareholders are essentially contractual); Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) (describing the duty to pursue the interests of the common shareholders as the general rule governing directors' actions); HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12922, 1993 WL 205040, at *745 (Del. Ch. June 9, 1993) ("[T]o a very large extent, to ask what are the rights of the preferred stock is to ask what are the rights and obligations created contractually by the certificate of designation."). *See also infra* note 172 and accompanying text.

159. *Trados*, 2009 WL 2225958, at *7 nn.38 & 42.

160. *Id.* at *7.

161. *Id.* at *8.

162. This interpretation of the 2009 *Trados* decision finds support in the recent post-trial decision of the case, in which the Chancery Court explicitly recognized that the preferred designees "faced a conflict of interest as dual fiduciaries." *See In re* Trados Inc. S'holder Litig., No. 1512-VCL, 2013 WL 4511262, at *22 (Del. Ch. August 16, 2013).

163. *Trados*, 2009 WL 2225958, at *6 (quoting Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)).

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the fact that the Trados directors had "additional significant relationships to preferred stockholders" only made the court's decision easier, providing further evidence that the directors were interested in the Trados merger.[164]

3. The Residual Control Constraint

The bottom line that emerges from the *Trados* decision is that the right to benefit from directors' adaptive decision-making—what the court in *Trados* dubbed a director's "discretionary judgment"[165]—follows from the special status shareholders enjoy in corporate law and cannot be privately ordered in favor of NCE investors.[166] Such investors can, at best, restrict the extent of the directors' required allegiance to shareholder interests by bargaining for specific control rights. But the residual control directors enjoy once they have honored all the corporation's contractual obligations is not negotiable. It can only be exercised to the benefit of shareholders,[167] regardless of whether a director has been appointed by the shareholders themselves or another corporate constituency.

This constraint affects both the monitoring and enforcement functions of constituency directors. Any right claimed by NCE investors through the actions of their board designees needs to be grounded on explicit contractual provisions, unless this right "is not to a preference as against the common stock but rather a right shared equally with the common [shareholders]."[168] Thus, constituency directors will be prevented from disclosing information to their sponsors where a conflict of interest arises with the shareholders, unless the sponsors have bargained for a confidentiality agreement that includes a specific right to a differing course of action.[169] Likewise, constituency directors will be allowed to

164. *Id.* at *8 n.43.

165. *Id.* at *7.

166. As stated in another oft-repeated Delaware opinion, "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests." Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988). *Trados* adds to this well-settled principle that a director's obligation of undivided loyalty preserves the integrity of the shareholders' exclusive right to benefit from directorial power. *Cf.* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 601–07 (1997) (characterizing the "exclusive benefit principle" as the fundamental predicate of the fiduciary obligation of loyalty).

167. *See* Macey, *supra* note 36, at 1279–80 (arguing that "fiduciary duties are themselves a form of residual claim. . . . [S]hareholders [are] entitled to the residual legal rights that remain after the nonshareholder constituencies have reached their own agreements with the corporation.").

168. *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986).

169. *See* Morris et al., *supra* note 126, at 6, 9.

take actions contrary to the interests of the shareholders only so long as they are contractually entitled to do so.[170]

Under this approach, Delaware courts have foreclosed the possibility of allowing for additional (i.e., non-contractually specified) protective mechanisms for NCE investors. Building on its prior decision in *Trados*, the Delaware Chancery Court made this point clear in its 2010 decision in *LC Capital Master Fund*.[171] Faced again with a conflict of interest between common and preferred shareholders in matters relating to a merger, the court held that bestowing more on the preferred shareholders than they were contractually entitled to would "give them leverage that they did not fairly extract in the contractual bargain, a hold-up value of some kind that acts as a judicially imposed substitute for contractual protections that they could have, but did not obtain . . . ."[172]

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170. For example, the court in *Trados* referred several times to the absence of a "drag-along" contractual provision that enabled the preferred shareholders to force through the sale of the company, suggesting that the case would have been dismissed in these circumstances. *See In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009). It bears emphasis, however, that commentators remain skeptical of the effectiveness of drag-along rights in *Trados*-like cases. *See* Bratton & Wachter, *supra* note 29, at 1890 ("*Trados* disrupted the contracting field, *impairing* the operation of drag-along rights.") (emphasis in original). Drag-along provisions provide for a discretionary right of a given shareholder class (e.g., the preferred shareholders) to sell or merge the company, by contractually securing other shareholders' advanced promise to support the merger. *See* Nat'l Venture Capital Ass'n (NVCA), Model Voting Agreement § 3, at 5–10 (Aug. 2013) [hereinafter Model Voting Agreement]. After *Trados*, however, there are significant issues with these provisions. First, it remains unclear whether obtaining the shareholders' advanced consent to a merger is sufficient to avoid issues of directors' self-dealing in preferred controlled boards. Second, it might be impossible to obtain the approval of all of a company's "other shareholders", especially if one considers that venture capital deals frequently involves several layers of investors. *See* Memorandum from Christopher L. Kaufman & Kathleen M. Wells to Law Firm Clients, Venture Capital Investing: Can the Liquidation Preference of Preferred Stock Over the Common Stock be Protected Where the Common Stock Receives Little or Nothing in an Exit? 5 (Oct. 21, 2010) (on file with author) [hereinafter Kaufman & Wells Memorandum]; Bratton & Wachter, *supra* note 29, at 1891. To address these issues, in 2010 the NVCA introduced a convoluted contractual alternative to standard drag-along rights. This alternative provides for the negotiation of a contractual pre-commitment by the company itself to commence a sale or merger process upon request of a given shareholder class (e.g., the preferred shareholders), coupled with that class' right to redeem its shares in case of board refusal to approve the merger. *See* Model Voting Agreement, § 1.2-1.3. These provisions are finalized, on the one hand, to limit board involvement in conflicted situations (i.e., directly avoid the rise of *Trados*-like issues) and, on the other, to frame the possible board's approval of a conflicted situation as a contractually "forced", and therefore disinterested, decision (i.e., indirectly avoid a *Trados*-like issue). Yet, because Delaware law ultimately requires board approval of a merger, it is unclear how far one can go in directly limiting *Trados*-like director conflict issues. Kaufman & Wells Memorandum, *supra*, at 5. Moreover, in *Trados*-like circumstances redemption is unlikely to be a viable option, since companies that navigate in troubled water will most likely be unable to redeem outstanding preferred claims. Accordingly, the threat of redemption is unlikely to work as an effective device to make the board's approval of a merger look non-interested to courts. *See* Bratton & Wachter, *supra* note 29, at 1892–93.

171. LC Capital Master Fund, Ltd. v. James, 990 A.2d 435 (Del. Ch. 2010).

172. *Id.* at 451. In *LC Capital Master Fund*, Vice Chancellor Strine also clarified once and for all

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This approach, however, misses two important points. First, there might be corporate situations (such as startups and declining corporations) where NCE investors are exposed to virtually the same contracting problems that common shareholders face, and for which the shareholder franchise and fiduciary protection provide a solution. Second, anticipating that bargaining for specific control rights is insufficient to protect their interests in these situations, NCE investors appoint constituency directors precisely to benefit from discretionary powers that extend beyond whatever contractual protections they have bargained for.

It is thus unsurprising that *Trados* and its progeny have attracted a tremendous amount of commentary, especially from concerned private equity lawyers.[173] This great deal of attention reflects the difficulties that NCE investors may bear under the Delaware courts' strict adherence to the undivided loyalty principle.[174]

But the limitations arising for NCE investors under current fiduciary rules do not just raise distributive concerns. Instead, as the next Part will show, they also raise allocative concerns because they may deter NCE investors who would otherwise invest in a project.

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that the precedents established in Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584 (Del. Ch. 1986). and *In re* FLS Holdings, Inc. S'holders Litig., No. 12623, 1993 WL 104562 (Del. Ch. Apr. 2, 1993, *revised* Apr. 21, 1993), are just circumscribed exceptions to the general principle that preferred rights are contractual in nature. *LC Capital Master Fund*, 990 A.2d at 447 ("The broad language in *FLS Holdings* and *Jedwab* must, I think, be read against [their] factual backdrop. . . . Without this factual context, those opinions are otherwise in sharp tension with the great weight of our law's precedent in this area.").

173. *See* Marilyn B. Cane et al., *Recent Developments Concerning Preferred Stockholder Rights Under Delaware Law*, 5 VA. L. & BUS. REV. 377, 390 (2011); Marita Makinen et al., *Acqui-Hires for Growth: Planning for Success*, 28 VENTURE CAPITAL REV. 31, 37 (2012).

174. In confronting the hurdles caused by the *Trados* decision, most private equity lawyers have advised investors faced with potential conflicts of interests to call for a vote of independent (i.e., non-constituency) directors. Some among them, however, rightly worry that even such directors may be obligated to prefer the common shareholders' interests absent a specific contractual provision in the investors' favor. *See* Kaufman & Wells Memorandum, *supra* note 170, at 5. More generally, because of the director conflict concerns raised by *Trados* and other similar cases, both legal advisors and the NVCA have strongly encouraged investors to focus on advanced planning and contractual specification to protect their investments. *See* Model Voting Agreement, *supra* note 170 and accompanying text (outlining the NVCA's attempt to contractually avoid *Trados*-like circumstances); *see also* Steven M. Davidoff, *A Lesson in Control*, N.Y. TIMES DEALBOOK (Nov. 10, 2010, 2:59 AM), http://dealbook.nytimes.com/2010/11/10/a-lesson-in-control. Yet they have also acknowledged that this is a task ridden with feasibility issues, pointing out that "[t]here has been no perfect [contractual] solution advanced to date for the dilemma posed by these court decisions." Kaufman & Wells Memorandum, *supra* note 170, at 4; Bratton & Wachter, *supra* note 29, at 1890 (arguing that "on the facts of *Trados*, no available contractual circumlocution exists").

B. The Economics of Undivided Loyalty

The limitations imposed by the principle of undivided loyalty on the use of constituency directors, both as a monitoring and as an enforcement device, have social welfare implications, which are best illustrated by a game theoretic hypothetical.

1. A Game Theoretic Illustration

Consider Del. Corp. Inc., a commercial company incorporated in Delaware. Del. Corp. Inc. started its business with a total asset value of $100, equally funded by the issuance of common shares and debt. However, after two years in business ("period one"), the company's financial prospects have become dire. During the initial period, Del. Corp. Inc. has been unable to generate positive cash flows and, as a result, its asset value has fallen to $55. The company's creditors, concerned with the negative outlook, have threatened to accelerate the repayment of debt. In response to these hurdles, Del. Corp. Inc.'s board has engaged in a search for financing and strategic options, identifying two possibilities. The first is to liquidate the company for $55. This option would allow the company to repay the outstanding debt in full but would leave the common shareholders with only $5. Alternatively, Del. Corp. Inc. could issue $100 in preferred stock—carrying a fixed dividend of $20—to a private equity fund that specializes in distressed investments.[175] This alternative option would allow the company to refinance its outstanding debt while also providing enough funds to enable it to continue operations for some additional time ("period two"). For simplicity, assume that if the board opts for the refinancing strategy, the business will be terminated at the end of period two, with the preferred shareholders having the right to receive their liquidation preferences (i.e., capital plus dividends) in a lump sum and the shareholders being entitled to the residual.[176]

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175. *See supra* note 18 (discussing, among others, the rise of preferred equity investments in distressed debt).

176. Note that the above hypothetical can be easily rewritten where Del. Corp. Inc. is a startup. To this end, assume that Del. Corp. Inc. starts out with an equity capital of $5 in period one. This leaves the company in need of $100 before it can fully implement its business, e.g., the development of a new technological device. Further, assume that after exploring various alternatives to raise these funds, the company's board is confronted with the decision of whether to issue $100 in preferred stock to venture capitalists who demand a dividend payment of $20. As above, further assume that the parties' agreement provides for the venture capital's cash flows to be distributed in full after period two, either because the company is liquidated or, alternatively, an IPO occurs. The conversion rights of venture

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Assume now that in period two, there can be two equiprobable states of the world (i.e., future scenarios), *State 1* and *State 2*. The realization of these states of the world depends on exogenous market conditions—what game theorists call "a move from nature" (or the "Nature Player").[177] Moreover, which state of the world materializes is private information of the board. This means that the preferred shareholders are either unable to observe which state of the world will materialize in period two or verify the realized state of the world to a third party (e.g., the court). Hence, the parties cannot write a state-contingent contractual agreement. Further assume that under each state of the world, the board can either choose a *conservative* strategy or an *expansive* strategy. The former promises a given payoff with certainty, such as the sale of the company. The latter, instead, involves a riskier course of action, such as continuing to operate the company, and therefore involves another move from the Nature Player.[178] Assume that this move can be either *Good* (involving a positive outcome for the selected course of action) or *Bad* (involving a negative outcome).

Game theory analysis helps us to better understand how the parties in our hypothetical will strategically interact. Using an extensive form game,[179] the order of actions and events of the example can be described as follows:

1. The board moves first, deciding whether to propose (action: *propose*) or not propose (action: *not propose*) the contract to the preferred shareholders;

2. the preferred shareholders move second by accepting (action: *accept*) or rejecting (action: *reject*) the board's contract;

3. the Nature Player plays third, randomly determining the state of the world, *State 1* or *State 2*;

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capitalists are left out of the picture in order to keep the startup context comparable with the declining corporation context. This simplification does not affect qualitative results.

177. *See* ERIC RASMUSEN, GAMES AND INFORMATION 27 (4th ed. 2007) ("Nature is a pseudo-player who takes random actions at specified points in the game with specified probabilities."); STEVEN TADELIS, GAME THEORY: AN INTRODUCTION 15 (2013) ("Nature chooses a probability distribution over the outcomes . . . .").

178. In reality, all future states of the world involve some degree of uncertainty (i.e., a move from the Nature Player). For simplicity, however, I assume away the role of uncertainty when the action is *conservative*. This simplification does not affect qualitative results.

179. An extensive form game "models explicitly the actions that the players take, the sequence in which they take them, and the information they have when they take these actions." DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 50 (1994).

4. the board plays again deciding whether to take a conservative strategy (action: *conservative*) or an expansive strategy (action: *expansive*);

5. only when the board plays expansive does the Nature Player play again, deciding with equal probability between a good state (*Good*) and a bad state (*Bad*).

The game tree that follows in Figure 2 below specifies the moves available to each player at each point in the game and the players' payoffs under the various outcomes. The tree's "decision nodes" represent the different points of the game and the board's initial decision *propose*/*not propose* represents the "root node" (or "initial node") of the game. Each branch leaving a decision node represents a player's "move" or "action," while a complete series of actions represents a player's "strategy."[180] In our game, however, only the board has multiple strategies, each of which includes multiple actions. The preferred shareholders, instead, only have two strategies, each of which is a simple action (i.e., *refuse* or *accept*). Note that we do not consider the Nature Player here because her introduction basically serves to represent uncertainty about the future. That is, the Nature Player selects strategies randomly—based on probability distributions rather than payoff strategies. The pair of numbers at each endpoint of the tree (the "leaf" or "terminal nodes") represents the players' payoff, expressed as gross returns. The left-hand number is the payoff to the common shareholders as "owners" of Del. Corp. Inc.[181] The right-hand number is the payoff to the preferred shareholders.

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180. *See* RASMUSEN, *supra* note 177, at 27, 31.

181. *See supra* note 11 and accompanying text (describing the special status enjoyed by shareholders as holders of property rights and the rationale for this status).

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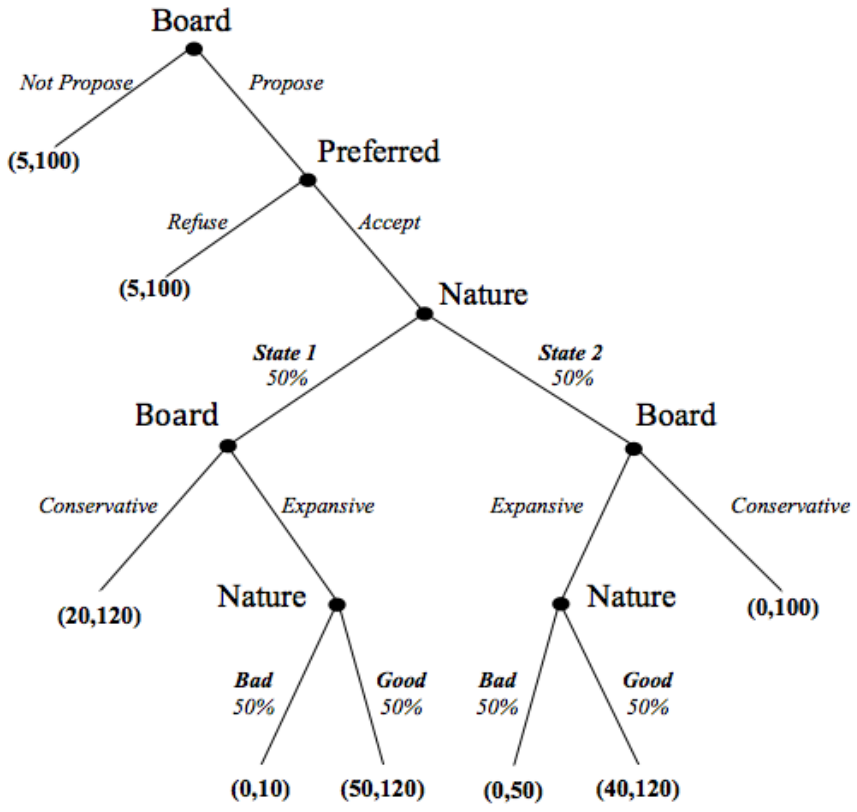

Fig. 2. Game in extensive form

In order to solve the game and identify the parties' equilibrium strategies, we proceed by backward induction. This means that we start from the end of the tree and move back towards the beginning (the "root node") to compute optimal actions.[182] In practice, we first assign to the last player the choice that maximizes her expected payoff then we move to the second-to-last player and, based on the last player's choice, we determine the choice that maximizes the second-to-last player's expected payoff, and so on. For the reasons explained above, we leave aside the Nature Player's "choice" of *Bad* or *Good* and we make the board the last player, which has to decide whether to play *conservative* or *expansive*. In computing the

182. *See* DREW FUDENBERG & JEAN TIROLE, GAME THEORY 67–69 (1991).

board's actions, we assume a rule of the game[183] consistent with the principle of undivided loyalty and requiring all directors to exercise residual control to the exclusive benefit of the common shareholders.[184]

In *State 1*, we assign the action *expansive* to the board because the common shareholders' expected payoff from this action is (50% * $0)+ (50% * $50) = $25, while it is only $20 from *conservative*. In *State 2*, we also assign *expansive* to the board because the common shareholders' expected payoff is (50% * $0) + (50% * $40) = $20 from this action, while it is $0 from *conservative*. Hence, the board will always choose *expansive*, regardless of whether the Nature Player chooses *State 1* or *State 2*. Under this outcome, we move to compute the preferred shareholders' strategy. Under (*State 1, expansive*) the preferred shareholders expect to receive (50% * $10) + (50% * $120) = $65. Under (*State 2, expansive*), they expect to receive (50% * $50) + (50% * $120) = $85. Hence, the preferred shareholders' overall expected payoff from investing in Del. Corp. Inc. is equal to (50% * $65) + (50% * $85) = $75, which is clearly below their reservation utility[185] ($100). This implies that the preferred shareholders will always play *refuse*, with the result that the common shareholders will only receive their reservation utility ($5).

For the purposes of this discussion, it is important to emphasize that no feasible dividend increase can induce the preferred shareholders to accept the contract under a "rule of the game" that requires the board to exercise its residual control power to the exclusive benefit of the common shareholders. This is because, under the board's expansive strategy, the overall expected cash flows produced by Del. Corp. Inc. are below the preferred shareholders' reservation utility. Indeed, expected cash flows are (50% * $10) + (50% * $170) = $90 under (*State 1, expansive*) and (50% * $50) + (50% * $160) = $105 under (*State 2, expansive*). Hence, overall expected cash flow under *expansive* equals (50% * $90) + (50% * $105) = $97.5, which is below the preferred shareholders' reservation utility ($100).

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183. *See* Fama & Jensen, *supra* note 55, at 302 (describing the combination of internal contracts and external legal constraints that specify the agents' rights, performance criteria, and payoff functions as rules of the game).

184. Under the current doctrine of undivided loyalty, this rule would remain unchanged even if the preferred shareholders gained control of the board through the appointment of a majority of constituency directors. *See supra* Part II.A.2. For convenience, however, in this first part of our hypothetical we assume that the board does not include constituency directors.

185. The reservation utility is the minimum level of utility the principal needs to guarantee the agent for the latter to accept the principal's contract.

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This result flies in the face of conventional assumptions that protecting NCE investors ultimately comes down to bargaining for the right price-based compensatory mechanisms.[186] Indeed, these mechanisms might be unavailable in the absence of sufficient "pleadgeable income"—visible asset value (whether actual or expected)—backing a corporation's obligations.[187] Further, as the next section will illustrate, this result suggests that where such mechanisms are unavailable to protect the interests of NCE investors—as is likely to be the case in start-ups and declining corporations—the appointment of unconstrained constituency directors might be a necessary condition for NCE investments to take place.

2. Social Welfare Maximization

Suppose now that anticipating the preferences of the board for expansive strategies, the preferred shareholders bargain for the appointment of a number of constituency directors that is sufficient to obtain board control. Further suppose that this move can change the rules of the game, allowing constituency directors to exercise their residual control over the corporation in the exclusive interest of the preferred shareholders. Proceeding again by backward induction, we first compute whether the board, as the last player, will play *conservative* or *expansive* under this different rule. In *State 1* we assign to the board the action *conservative* because the preferred shareholders' expected payoff from this action is $120, while it is only (50% * $10) + (50% * $120) = $65 from *expansive*. In *State 2* we also assign to the board the action *conservative* because the preferred shareholders' expected payoff from this action is $100, while it is only (50% * $50) + (50% * $120) = $85 from *expansive*. Hence, a board composed by a majority of constituency directors will always choose a *conservative* strategy, regardless of whether the Nature Player chooses *State 1* or *State 2*. Under this different outcome for the board's strategy, it is easy to see that the preferred shareholders will always play *accept*. This is because, with a board controlled by constituency directors, the overall expected cash flows produced by Del. Corp. Inc. are (50% * $120) + (50% * $100) = $110, which is higher than the preferred shareholders' reservation utility ($100).

186. *See* Macey, *supra* note 45, at 39 (arguing that the issue in protecting the interests of NCE investors is not whether these investors "can protect themselves via contract, but whether they are willing to pay for such protection").

187. *See* TIROLE, *supra* note 16, at 116–17.

Hence, the appointment of constituency directors who are free to pursue partisan interests makes the investment worth undertaking for the preferred shareholders in a situation where it would otherwise not be. But what matters most is that the appointment of unconstrained constituency directors *also* benefits the common shareholders. Indeed, the participation of the preferred shareholders increases the common shareholders' expected payoff. While the common shareholders receive only their reservation utility, $5, when the preferred play *refuse*, they receive (50% * $20) + (50% * $0) = $10 when the preferred play *accept*.

This simple example shows that, by depriving constituency directors of the ability to act as representatives of their sponsors, the obligation of undivided loyalty may ultimately jeopardize the very interests of shareholders. This occurs because the current approach to pursuing shareholder welfare (as a proxy for overall welfare)[188] focuses only on part of the events and actions occurring in the game between the shareholders and NCE investors: ex post conflicting decision-making. But it overlooks the ex ante bargaining part of the game. Using our hypothetical again to better illustrate this, we can say that current corporate fiduciary duty rules evaluate shareholder welfare by taking into consideration only the subgame that starts at the intermediate decision node *(conservative, expansive)*[189]—overlooking that the overall game starts, instead, at the root node *(propose, not propose)*.[190]

Thus, the question in *Trados* should not have been whether the common shareholders would have been better or worse off had the merger

188. *See supra* note 141 (explaining that legal scholars as well as courts have consistently identified shareholder interests as the best proxy for overall welfare).

189. A subgame is "[a] *node* or a set of *nodes* of an *extensive form game* that can be viewed in isolation." BAIRD ET AL., *supra* note 179, at 316 (emphasis in the original).

190. It is important to observe that this approach to interinvestor conflicts radically departs from recent scholarly proposals suggesting that enterprise value maximization should be the benchmark of directorial conduct. *See, e.g.*, Bratton & Wachter, *supra* note 29, at 1885–86 (suggesting that enterprise value maximization should replace stock value maximization as the benchmark of directors' conduct); Baird & Henderson, *supra* note 27, at 1328 (suggesting that most law and economics scholars favor the adoption of a firm-maximization norm over the current replacement of the shareholder wealth maximization norm). As pointed out by the Delaware Chancery Court in the *Trados* post-trial decision, the enterprise approach is ill suited to serve as a proxy for overall wealth maximization because—among other problems—is difficult to administer and, therefore, likely to introduce uncertainty in the corporate landscape. *See In re* Trados Inc. S'holder Litig., No. 1512-VCL, 2013 WL 4511262, at *18 n.16 (Del. Ch. Aug. 16, 2013). By sticking to the shareholder wealth maximization norm, the approach to interinvestor conflicts advocated by this Article avoids these problems. At the same time, however, it eliminates the inefficiency raised by the current, limited reading of this norm, which is likely to jeopardize rather than advance shareholder interests in *Trados*-like circumstances.

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not occurred, as the court assumed.[191] Instead, it should have been whether the shareholders would have been better or worse off *without the preferred financing*—which would have likely been unavailable had the preferred shareholders anticipated that their board designees were not entitled to approve a merger of the company unless it also benefitted the common shareholders. This different approach to the economics of the parties' exchange exposes the fact that satisfying the participation constraint of NCE investors is the first-order problem for shareholders. Vesting constituency directors with the power to exercise residual control in favor of their sponsors, potentially even at the shareholders' expense, is a necessary condition to satisfy this constraint. Thus, in similar circumstances, shifting residual control rights from shareholders to NCE investors is a means to serve rather than jeopardize shareholder interests.

These observations suggest that the obligation of undivided loyalty may stand in the way of welfare-maximizing contractual solutions and reduce a corporation's ability to attract NCE capital. From this perspective, the risk that the shift of residual control rights from shareholders to NCE investors may, in some circumstances, result in value-decreasing ex post decisions is a second-order problem. Indeed, because of their fixed payoff structure, NCE investors may prefer conservative (i.e., lower risk) actions even when the undertaking of riskier actions yields higher overall expected payoff.[192] But this risk cannot be placed on equal footing with the risk that such investors may walk away from a prospective exchange. One must first consider whether conditions exist for an exchange to take place; only then can one consider whether there is room for increasing the gains from that exchange. Moreover, as the next Part will explain, Coasean bargaining (i.e., efficient renegotiation) will generally be available to redress the potential ex post downside that shifting residual control rights to NCE investors may engender.[193]

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191. *See In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009).

192. See Fried & Ganor, *supra* note 107, at 994–95. ("Because of the preferred shareholders' liquidation preferences . . . . preferred-dominated boards may favor immediate 'liquidity events' (such as dissolution or sale of the business) even if operating the firm as a stand-alone going concern would generate more value for shareholders."); Bratton & Wachter, *supra* note 29, at 1186 ("Preferred, as a senior claim, will avoid taking value-enhancing risk in a case where common, as the at-the-margin residual interest, would assume the risk.").

193. The contracting part of the Coase Theorem states that parties will find it efficient to contract around externalities in order to reach a Pareto improvement. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). In more general terms, this means that parties facing an inefficient outcome will have incentives to renegotiate their respective entitlements to reach a value-maximizing result.

3. Coasean Bargaining

We have seen that a board with a majority of constituency directors will always choose the action *conservative* over the action *expansive*. This is because, under the preferred shareholders' payoff structure, *conservative* is always more profitable for them than *expansive*. However, from a social welfare perspective, taking *conservative* is only efficient upon the realization of *State 1*—when the overall cash flow value associated with this action is $140, while that associated with *expansive* is (50% * $10) + (50% * $170) = $90. This is not so upon the realization of *State 2*—when the overall cash flow value associated with *conservative* is $100, while that associated with *expansive* is (50% * $50) + (50% * $160) = $105. Therefore, vesting constituency directors with the ability to further the interests of the preferred shareholders leads to a welfare loss of $5 upon the realization of *State 2*.

It is reasonable to infer, however, that in similar circumstances there would be room for Coasean bargaining between the parties. This is because the expected benefit accruing to the preferred shareholders from the board's choice of *conservative* over *expansive* in *State 2* is lower than the loss accruing to the common shareholders: $100 − $85 < $20. Hence, the parties will have incentives to renegotiate their original agreement so that choosing *expansive* in *State 2* would make both the preferred shareholders and the common shareholders better off. To satisfy this condition, the common shareholders should leave part of the surplus generated by the choice of *expansive* under *State 2* ($5) to the preferred. Specifically, the preferred shareholders' expected payoff under (*State 2, expansive*) should be equal to the amount they would receive under (*State 2, conservative*) ($100) plus half of the surplus ($2.5).[194] In practice, this would require an ex post increase of the preferred shareholders' dividends from $20 to $55. Under this dividend increase, if *expansive* is successful (i.e., the Nature Player chooses *Good*), the preferred shareholders would now obtain $155. Hence, the expected value to the preferred of (*State 2, expansive*) would become (50% * $50) + (50% * $155) = $102.5, which is higher than the $100 they would obtain under (*State 2, conservative*). Similarly, the expected value for the common shareholders would increase from $0, which is what they would receive under (*State 2, conservative*), to (50% * $0) + [50% * ($160 − $155)] = $2.5 under (*State 2, expansive*).

194. Here the assumption is that the parties have equal bargaining power, which leads to the Nash bargaining solutions of splitting the renegotiation surplus equally. *See infra* note 208 (defining Nash equilibrium).

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It is worth mentioning a final note about the possibility that efficient renegotiation may fail. While in principle the availability of more gains from trade should always lead to the efficient reallocation of the parties' entitlements, in practice one cannot exclude the possibility that renegotiation may fail in some circumstances.[195] This may be the case if, for example, bargaining over the division of the renegotiation surplus requires excessive time and resources relative to the size of the NCE investment in the corporation.[196] But the risk that renegotiation may fail does not alter the bottom line in the discussion: the ex ante benefits arising from vesting constituency directors with the ability to further their sponsors' interests outweighs the potential ex post downside that may arise from this contracting model. Put another way, in order to satisfy the participation constraint of NCE investors, the shareholders need to bear the risk that ex post renegotiation may fail.

C. Monitoring and Contract Self-Enforcement

The above example has assumed that the preferred shareholders need to gain board control in order to fully protect their interests. In practice, however, NCE investors often employ contracting models that rely on the appointment of only a minority of constituency directors. Under these contracting models, designating investors expect constituency directors to provide them with information on ex ante unforeseeable contingencies, facilitating the effective use of specific contractual protections. In this light, slightly amending the rules of the game for NCE investors—by releasing constituency directors from confidentiality strictures—would seem sufficient to eliminate current inefficiencies facing corporate actors.

But the frictions arising from confidentiality strictures are not the only problem that may affect this alternative function of constituency directors.

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195. Some commentators have observed that information asymmetry between the preferred shareholders controlling the board and the common shareholders may prevent efficient renegotiation. *See* Fried & Ganor, *supra* note 107, at 997–99. However, unless the board includes only constituency directors—which is a remote possibility—the common shareholders will be able to rely on their own designated directors for regular information on board and company matters. *See infra* Part II.C. Hence, information asymmetry is unlikely to represent a major obstacle to efficient renegotiation between the parties in corporate contexts including constituency directors.

196. Indeed, this appears to have been one of the reasons why the preferred shareholders in *Trados* decided to go ahead with the merger in spite of the company's improved performance. *See Trados*, 2009 WL 2225958, at *2 n.2. More generally, we can say that "the seemingly irrational act of shutting down an economically viable entity is rational when viewed from the perspective of the venture capitalist confronted with allocating time and capital among various projects." William A. Sahlman, *The Structure and Governance of Venture–Capital Organizations*, 27 J. FIN. ECON. 473, 507 n.12 (1990).

This is because access to private information might be insufficient to make contractual protections effective, absent bargaining levers that can make those protections self-enforcing. Constituency directors can reduce informational problems arising between contracting parties but are unhelpful when it comes to verifying information to third parties (i.e., courts). And, as noted above, verifiability issues may potentially compromise the ability of courts to properly enforce contracts in contexts where asymmetric information is significant, such as startups and declining corporations.[197]

The fact that some NCE investors systematically employ contracting models in which the function of constituency directors is not finalized to obtain board control suggests that these investors enjoy sufficient bargaining levers to make their contractual protections self-enforcing. For example, it is self-evident that the ability of the government to make recourse to regulatory measures helps to minimize the need for ex post judicial enforcement. Indeed, the threat of retributory regulatory interventions or other government actions will be sufficient in most cases to ensure that the contractual protections the government has bargained for have teeth. It is thus unsurprising that under TARP programs, the U.S. government has opted to use constituency directors in their monitoring function.[198] Combined with the large body of prudential rules at the government's disposal to regulate bank conduct,[199] the access to private bank information provided by government-appointed directors becomes a fully viable mechanism to ensure effective investment protection.

The ability to strike offers unionized workers a functionally similar lever to make collective contracts self-enforcing. While, in practice, strikes are relatively infrequent in the United States, they nonetheless constitute a valid tool to make contracts self-enforcing. As long as the threat of a strike and its attendant negative effects on production are credible, its existence will produce an equilibrium under which contractual protections are effective. In this respect, data from the 1998 General Motor (GM) strike is

197. *See supra* text accompanying note 93.

198. *See supra* notes 118–25 and accompanying text.

199. Prudential regulation comprises the system of key requirements and restrictions that regulators employ to maintain the solvency of financial institutions. For a general discussion of the basic principles of the prudential regulation of banks in the United States, see RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS (4th ed. 2009).

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telling. The strike cost GM $809 million[200] and caused a U.S. market share loss of about ten percent.[201] This was compounded by adverse effects on satellite businesses as well as negative macroeconomic impacts, producing a direct decline in the 1998 U.S. GDP growth.[202] And while the 2007 national GM strike only lasted two days, it cost GM $100 million per day.[203] Therefore, as with the government, a constituency director's monitoring function is likely to be sufficient to ensure effective protection of unionized workers' interests, which is consistent with the observed practice of union-nominated directors.[204]

But, in general, the very same features that make the appointment of constituency directors desirable may limit the availability of self-enforcing mechanisms.[205] This may potentially frustrate the effectiveness of contracting models that rely only on a constituency director's monitoring for protecting the interests of NCE investors.

As an illustration, let us modify the hypothetical from Part II.B.1 as follows. First, let us assume the preferred shareholders bargain only for the appointment of one constituency director, whom they expect to fulfill an informational role. This means that, while the rule that requires the board to give their loyalty exclusively to the common shareholders remains unchanged, the preferred shareholders will now receive information contingent on both the board's strategy and the moves of the Nature Player (i.e., future states of the world). Second, anticipating the board's preference for expansive strategies, let us assume that the preferred shareholders bargain for a right to accelerate the preferred stock financing should the board adopt an *expansive* strategy without their consent. Third, the Nature Player chooses *State 1*. Fourth, the exercise of the preferred shareholders' acceleration right under *State 1* triggers the company's piecemeal liquidation, yielding overall cash flows of $50.

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200. Michael Ellis, *GM, Hit by Strikes, Reports $809 Million Q3 Loss*, REUTERS NEWS, Oct. 13, 1998, *available at* WESTLAW.

201. Michael Ellis, *GM Hopes to Gain Back Market Share by Year-end*, REUTERS NEWS, Oct. 5, 1998, *available at* WESTLAW.

202. Keith Bradsher, *U.A.W. Strike Is Being Felt Far from Flint: Economists Cut Back U.S. Growth Estimates*, N.Y. TIMES, June 26, 1998, at D1.

203. James Quinn, *GM Hit by First National Car Strike in 31 Years*, THE TELEGRAPH (Sept. 25, 2007, 12:01 AM), http://www.telegraph.co.uk/finance/markets/2816470/GM-hit-by-first-national-car-strike-in-31-years.html.

204. *See* Appelbaum & Hunter, *supra* note 112, at 281 (observing that boards including union representatives "have one or more directors, but fewer than a majority, nominated by a union").

205. *See supra* text accompanying notes 94–96.

In order to compute optimal actions, we start this time by representing the game between the board and the preferred shareholders in its strategic form through the payoff matrix in Figure 3 below.[206]

		Preferred	
		Acceleration	*No Acceleration*
Board	*Conservative*	20 / 120	20 / 120
	Expansive	0 / 50	25 / 65

Fig. 3. State 1 Game in strategic form

Under this modified version of the hypothetical, both players have two strategies, each including only a simple action. The board can choose either *conservative* or *expansive*. The preferred shareholders can choose either *acceleration* or *no acceleration*. Expected payoffs are indicated in the matrix's interior, with the left-hand number indicating the common shareholders' expected payoff and the right-hand number indicating the preferred shareholders' expected payoff. If the preferred shareholders choose *no acceleration*, the parties' expected payoffs will remain the same as in the game described in Part II.B.1.[207] Instead, if the preferred shareholders choose *acceleration* when the board plays *expansive*, Del. Corp. Inc. is liquidated and the cash flows (i.e., $50) are entirely captured by the preferred shareholders.

This matrix shows that there are two Nash equilibria in which each player makes the best possible decision taking into account the other's decision:[208] (*expansive, no acceleration*) and (*conservative, acceleration*). Thus, one would assume that by playing *acceleration*, the preferred shareholders can induce the board to play *conservative* even when the

206. Strategic form games (or normal form games) model interaction between parties assuming that each party plays simultaneously without knowing the actions of the other party. *See* BAIRD ET AL., *supra* note 179, at 6–9.

207. If the board chooses *conservative*, the expected payoffs of the common shareholders and the preferred shareholders are $20 and $120; if the board chooses *expansive*, the parties' expected payoffs change to $25 and $65 respectively.

208. A Nash equilibrium (or bargaining solution) is one in which no single player could do better by changing her strategy if the other players stick to their own strategies. *See* John F. Nash, Jr., *Equilibrium Points in N-Person Games*, 36 PROC. NAT'L ACAD. SCI. 48, 48–49 (1950).

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board acts as representative of the common shareholders. But is this equilibrium sub-game perfect?[209] That is, does the equilibrium (*conservative*, *acceleration*) involve credible actions for each subset of sequentially ordered choices available to the parties? The answer to these questions can be obtained by transforming the game into its extensive form. To this end, consider the game tree represented in Figure 4 below.[210]

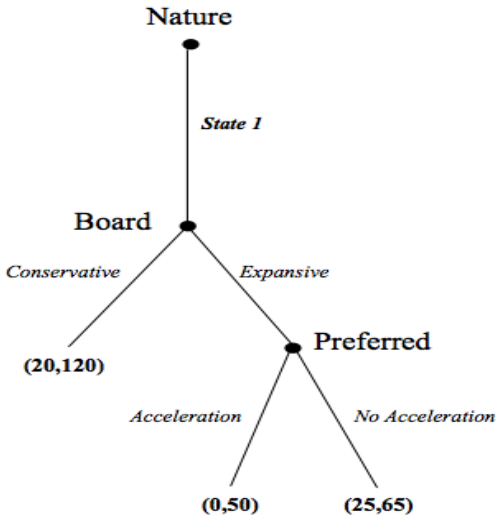

Fig. 4. State 1 Game in extensive form

Solving the game again by backward induction, we assign to the preferred shareholders, as the last player, the action *no acceleration*, since their expected payoff under this action is $65, while it is only $50 under *acceleration*. Under this outcome of the preferred shareholders' strategy, it is easy to see that the board will always choose *expansive* because the common shareholders' expected payoff is higher under this action than under *conservative* ($25 against $20). This shows that only the equilibrium (*expansive*, *no acceleration*) is sub-game perfect. Instead, the equilibrium (*conservative*, *acceleration*) involves a move by the preferred shareholders (i.e., *acceleration*) that is not credible. Liquidation, in fact, is not just costly for the common shareholders, but also for the preferred

209. A Nash equilibrium is sub-game perfect "if the players' *strategies* constitute a *Nash equilibrium* in every *subgame*." *See* BAIRD ET AL., *supra* note 179, at 316 (emphasis in the original).

210. Note that here, the tree's terminal nodes represent the players' expected, rather than actual, payoff: the left-hand number is the expected payoff to the common shareholders; the right-hand number is the expected payoff to the preferred shareholders.

shareholders, with the result that the latter prefer *conservative* to *expansive* but also *expansive* to *liquidation*.

This simple hypothetical shows that freeing constituency directors from confidentiality strictures might not always be sufficient to remedy the inefficiencies arising under existing corporate fiduciary duty rules. To better promote this goal, constituency directors should be released from the obligation of undivided loyalty as a whole. The discussion that follows attempts to outline the directions corporate law should take to implement this change.

III. CORPORATE LAW, PARTY AUTONOMY, AND THE POST-MODERN CORPORATION

Economic analysis suggests that contracting models that allow constituency directors to act as their sponsors' representatives respond to the first-order problem of facilitating a corporation's access to NCE capital. But existing corporate fiduciary duty rules ignore these models, admitting no modification to the principle that all directors owe undivided loyalty to shareholders. True to Berle and Means's classic view of the corporation[211] and its central concern with securing huge inputs of capital from many dispersed shareholders,[212] these rules conceive of the principle of undivided loyalty as the bulwark of shareholder protection against opportunistic managers. Viewed through this lens, it should come as no surprise that corporate law is almost exclusively focused on vertical agency problems[213] and the contract's failure to fully address such problems. It is assumed that addressing these problems is vital to ensure the continuing existence of the corporation.[214] In contrast, horizontal

211. *See* BERLE & MEANS, *supra* note 8, at 86–88.

212. *See supra* note 14.

213. *See, e.g.*, Bartlett, *supra* note 32, at 50 ("[C]orporate scholarship has focused primarily on the agency relationship between shareholders and managers in modern public corporations.") (footnote omitted); Blair & Stout, *supra* note 29, at 248–49 (describing the conventional view that "the central economic problem addressed by corporation law is reducing 'agency costs' by keeping directors and managers faithful to shareholders' interests"); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1374 (1993) ("Managerial accountability to shareholders is corporate law's central problem. Nonshareholder interests, if entitled to any legal protection at all, are for other, noncorporate law legal regimes."); Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 929 (1984) (defining the agency problem between managers and shareholders as the "master problem" of the modern corporation).

214. *See* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH U. L.Q. 403, 405 (2001) ("The idea that shareholders alone are the *raison d'être* of the corporation dominates contemporary discussion . . . .").

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agency problems are seen as subordinate at best,[215] in both significance and magnitude, and, in any event, as manageable by contract.

This model, however, is increasingly ill-suited to manage the sheer complexity of the post-modern corporation. In the last thirty to forty years, radical changes have occurred in corporate capital structures.[216] NCE capital, both in the form of debt and hybrid financial instruments, has grown into a steady, and often primary, source of corporate funding.[217] Corporate production has likewise undergone huge transformations. Corporations born out of the industrial age derived most of their value from physical assets and manufacturing activities. Instead, in the post-modern corporation, firm value increasingly depends on intangible assets, such as technological know-how, patents, research and development projects, brand names, or trade secrets.[218] Along the same lines, human capital has grown away from its neoclassical representation as an unspecified input[219] into an increasingly specialized corporate resource.[220]

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215. *See* Bartlett, *supra* note 32, at 39, 108 (suggesting that horizontal agency problems have been traditionally excluded from corporate law discussion about the modern public corporation).

216. *See* Merton H. Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. FIN. & QUANTITATIVE ANALYSIS 459, 460–63 (1986).

217. Richard Kopcke and Eric Rosengren have observed that during the last decade of the 1980s, corporations replaced "more than one-sixth of their outstanding stock with debt securities" and that such securities increasingly included hybrid features. Richard W. Kopcke & Eric S. Rosengren, *Are the Distinctions Between Debt and Equity Disappearing? An Overview*, *in* ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? PROCEEDINGS OF A CONFERENCE HELD AT MELVIN VILLAGE, N.H., OCTOBER 1989 1, 1 (Richard W. Kopcke & Eric S. Rosengren eds., 1989). Since the 1980s, this trend continued apace. For example, a recent study by Aswath Damodaran reports that in industrial sectors such as bank and financial services, maritime, power, property management, and telecommunication utilities, the level of leverage is higher than fifty percent of the firm's capital structure. Aswath Damodaran, *Debt Fundamentals by Sector*, DAMODARAN ONLINE (Jan. 2013), http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/dbtfund.htm.

218. A recent study by Leonard Nakamura shows that production from intangible-driven sectors, such as medical care, personal business services, education and research, and religious and welfare services has grown from ten percent in 1947 to about thirty percent in 2006. Leonard I. Nakamura, *Intangible Assets and National Income Accounting* 4–5 (Fed. Reserve Bank of Phila., Working Paper No. 08-23, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1285048. Correspondingly, investments in mass-production industries with tangible assets, such as agriculture, mining, manufacturing, transportation, and utilities, have declined from forty-nine percent of overall U.S. production in 1947 to a mere twenty percent in 2007. *Id.* at 4 (reporting Zvi Griliches's data); *see also* Leonard I. Nakamura, *What Is the U.S. Gross Investment in Intangibles? (At Least) One Trillion Dollar a Year!* (Fed. Reserve Bank of Phila., Working Paper No. 01-15, 2001), *available at* http://www.phil.frb.org/research-and-data/publications/working-papers/2001/wp01-15.pdf (presenting empirical evidence that U.S. corporations invest at least $1 trillion annually in intangibles).

219. *See, e.g.*, Lester G. Telser & Harlow N. Higinbotham, *Organized Future Markets: Costs and Benefits*, 85 J. POL. ECON. 969, 997 (1977) (describing the neoclassical view according to which "[i]n an organized market the participants trade a standardized contract such that each unit of the contract is a perfect substitute for any other unit").

220. In post-neoclassical economic theory, investments in human capital are modeled as one of the most significant contributors to economic growth. *See, e.g.*, Paul M. Romer, *Endogenous*

Viewed through this lens, the "hybridization" of many corporate structures has been a response to, among other factors,[221] the novel risk-sharing issues posed by the changes occurring in corporate production.[222] The almost exclusive use of convertible preferred shares to finance venture capital deals[223] provides the paradigmatic example of how technological changes have combined to shape capital structures that radically depart from the all-equity corporation of the Berle and Means' era.

In this corporate environment, the law's exclusive focus on shareholder-manager conflicts is increasingly out of step with the actuality of many corporate contexts. Horizontal agency problems in today's corporations have become as compelling as vertical agency problems, if not more. However, as shown by the discussion in Part II, current corporate fiduciary rules risk compromising the ability of corporate actors to devise welfare-maximizing solutions to such problems. In response, some scholars have suggested that "it may make sense to eliminate the concept of fiduciary duty from corporate law altogether."[224] While attractive, this solution overlooks the fact that the rationale for requiring directors to be loyal to shareholders—the severe incompleteness issues affecting the shareholders' corporate contract—is still applicable to the majority of corporate situations, although the economic significance of these contexts has radically decreased.

This Part suggests that a better approach to address the inefficiencies currently facing corporate actors would be to focus on reconciling corporate law and party autonomy. There is a normative case to be made for turning the duty of undivided loyalty into a default rule that parties could opt out of by appointing constituency directors. Enabling constituency directors to serve as their sponsors' board representatives while concurrently avoiding a complete disruption of corporate fiduciary rules, this reform intervention would bridge the gap between corporate

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Technological Change, 98 J. POL. ECON. S71 (1990).

221. *See* Franklin Allen, *The Changing Nature of Debt and Equity: A Financial Perspective*, *in* ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING, *supra* note 217, at 12–38 (providing a critical overview of the various factors that have been advanced in finance theory to explain financial innovations, including tax reasons, bankruptcy costs, signaling theories, and economic and control rights allocations).

222. *See, e.g.*, John D. Finnerty, *Financial Engineering in Corporate Finance: An Overview*, 17 FIN. MGMT., Winter 1988, at 14.

223. *See, e.g.*, WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 741 (7th ed. 2012); METRICK & YASUDA, *supra* note 12, at 163; Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 875 (2003).

224. Baird & Henderson, *supra* note 28, at 1315.

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practice and corporate law, to the benefit of all involved parties and, ultimately, society as a whole.

A. Enhancing Party Autonomy

Under the current corporate fiduciary regime, a director's obligation of loyalty to the common shareholders cannot be contractually altered.[225] Hence, "despite the directors' designation by some particular constituency, . . . fiduciary duties generally will trump contractual expectations in the corporate context."[226] But there is more to this story. As a result of the mandatory nature of directors' loyalty obligations, NCE investors may give up their investment expectations altogether, deciding to walk away from a prospective investment.

This Article thus suggests that a director's obligation of undivided loyalty to shareholders should be turned into a default rule that corporate actors would be free to bargain out of. In practice, corporate actors—NCE investors, on the one hand, and incumbent boards representing shareholders, on the other—should be free to bargain for contractual arrangements under which constituency directors are allowed to exercise residual control to the exclusive benefit of their sponsors. Under this waiver of the duty of loyalty, constituency directors would be vested with the ability to both provide their sponsors with full information about board and company matters and act in their sponsors' interests in situations where they conflict with those of shareholders. The only limits on the monitoring and enforcement functions of constituency directors would arise from the specific limits bargained for by the incumbent board in agreeing to their appointment.

In other words, opting out of the duty of loyalty would reverse the current allocation of property rights, under which directors are obligated to exercise residual control over the corporation to the exclusive benefit of shareholders unless required to do otherwise by a specific contractual

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225. Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1481 (1989) ("[T]he corporation's directors and officers have a duty of loyalty to the corporation that cannot be substantially altered."). There are, however, a few statutory exceptions to this rule. For example, Delaware law permits advance renunciation of "specified business opportunities or specified classes or categories of business opportunities" by express provision in the corporation's certificate of incorporation or by action of its board of directors. DEL. CODE ANN. tit. 8, § 122(17) (West 2011). Further, in several states—including Delaware—opting out of the fiduciary duty of loyalty is an active possibility in the context of limited liability companies. See 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES 524–25 (2d ed. 2011) (listing eighteen states as permitting full power to waive fiduciary duty).

226. Veasey & Di Guglielmo, *supra* note 126, at 774.

provision in favor of NCE investors. For example, under the current regime, constituency directors are required to keep material information confidential unless disclosure is specifically authorized by the parties' confidentiality agreement.[227] Under the proposal put forth here, instead, constituency directors could disclose any material information to their sponsors unless a confidentiality agreement specifically prevented them from doing so.

From the shareholders' perspective, this proposal would come with the obvious downside of shifting to them the risks that may arise out of contractual incompleteness issues in negotiating with NCE investors. This downside, however, should not be overestimated. The broader access to NCE capital that allows a waiver of the undivided loyalty principle would compensate shareholders for such risks. Additionally, as noted above, it is reasonable to assume that ex post renegotiation would be available to improve initial allocations of entitlements and increase gains from trading.[228]

Further, the contracting positions of shareholders under this proposed reform should not be conflated with that of NCE investors under current rules. In contracting with the corporation (i.e., the board as shareholders' representative), NCE investors start as "outsiders." The concern is whether they will be able to acquire enough inside information to effectively protect their investment expectations. The appointment of constituency directors in the first place is an attempt to address this concern. In contrast, under this Article's proposal, the board would bargain for contractual restrictions on a constituency director's discretion from its privileged position as an insider, being naturally better placed to bargain for effective protection. Moreover, under the realistic assumption that the board would continue to include at least one shareholder-designated director, the shareholders would also benefit from continued access to internal monitoring of constituency directors' actions.[229]

1. Scope

As concerns the scope of this Article's normative proposal, two important caveats are in order. First, the waiver of loyalty this Article envisions would not apply to conduct of constituency directors that is plainly self-serving, such as transactions that advance a constituency

227. *See supra* text accompanying note 169.
228. *See supra* Part II.B.3.
229. *See infra* Part III.A.2.

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director's own interest at the expense of the interests of shareholders and designating investors, like extracting lavish private benefits. For example, imagine that a board controlled by constituency directors used the company's money for regular private jet trips to the Augusta National Golf Club.[230] Unless constituency directors could justify these expenditures based on business purposes, this proposed reform would still hold them liable for breach of the duty of loyalty.

More generally, any director conduct that falls within the category of vertical agency problems—with the notable exception of conflict-of-interest transactions—would be excluded from the proposed waiver of loyalty. While the discussion has so far referred to vertical agency problems as exclusively pertaining to the shareholder-manager relationship, such problems translate to some extent to the shareholder-director relationship, since directors act as agents who exercise delegated corporate control on the shareholders' behalf. The collective nature of board decision-making[231] and the bonding mechanism provided by reputational concerns[232] scale down the scope and intensity of vertical agency problems affecting directors as compared to managers, but they cannot completely eliminate such problems.

As applied to constituency director issues, this means that there is room for purely self-serving director actions that should be excluded from the waiver of loyalty. Indeed, it is evident that extracting private benefits, paying out excessive compensation, taking cash out of the firm, and the like are all actions that damage designating investors and shareholders alike. With conflict-of-interest transactions, however, it might be difficult to tell self-serving conduct apart from conduct that is in the interest of the designating investors and only incidentally benefits constituency directors.[233] In response, a bright-line rule would be useful to guide courts'

230. Anecdotal evidence is full of such excesses. For example, Ross Johnson, the CEO of RJR-Nabisco during the 1980s, allegedly "jetted-off to some far-flung golf club" almost every weekend. BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 79 (1990). Johnson reportedly shared these benefits with his handpicked directors. *See id.* at 92–93.

231. *See* Bainbridge, *supra* note 55, at 32–38 (explaining that collective decision-making helps to constrain the agency problems that may affect board actions and, more generally, corporate relationships).

232. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive*, 75 U. CIN. L. REV. 921, 928 (2007) (arguing that "the basic premise" that applies to a corporate director, as compared to a manager, is "that her reputation as a whole matters more than her position with a particular corporation"). In the case of constituency directors, "relational concerns"—arising from the personal or professional ties that such directors often have with their sponsors—add to reputational concerns in constraining the risk of board opportunism. *See infra* note 243 and accompanying text.

233. *See* Baird & Henderson, *supra* note 28, at 1314–15 n.26. Baird and Henderson suggest that courts should retain ultimate power to distinguish these cases. *Id.* When applied to contexts involving

ex post decision-making. This rule, for example, could mimic the exculpatory clause—included in most "interested director" statutes—that enables the validation of a per se conflicting transaction if approved by shareholder vote.[234] In order to validate a per se conflicting transaction undertaken by constituency directors, approval by the designating investors could replace approval by the shareholders. Absent ratification by the designating investors, constituency directors would be liable for breach of the duty of loyalty.

Second, the ability of corporate actors to opt out of the duty of loyalty should not be limited to startups and declining corporations. These corporate contexts are illustrative, rather than exhaustive, examples of corporate situations in which the duty of loyalty is likely to interfere with welfare-maximizing contracting practices. For example, the financial manipulation of an investor's economic and control rights that has become increasingly common in today's corporate environment may also alter the traditional understanding of an investor's exposure to issues of contractual incompleteness. To the extent that "with the right package of derivatives, a debtholder can enjoy the same cashflow rights as an equityholder and vice versa,"[235] the contracting problems these investors face may likewise trade places. More generally, corporate actors will tend to have private information about the desirability of the waiver of loyalty in a given corporate situation. For this reason, their ability to opt out of loyalty obligations should not be subject to context-specific restraints.

2. Implementation

It is important to emphasize that this Article's proposal for reconciling party autonomy and corporate law does not involve a call for the extension of fiduciary duties to NCE investors. Thus, while this proposal shares the progressive idea that it might be efficient in some circumstances to take residual control away from shareholders and give it to other corporate

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constituency directors, however, this solution might potentially alter the parties' desired allocation of entitlements, with the risk of re-posing the very same problems the appointment of such directors is designed to avoid.

234. While "interested director" statutes include a number of variations across the various states that have adopted them, their common core provides that a conflicting transaction can be ratified through (i) approval by disinterested directors, (ii) shareholder ratification, and (iii) proof of the transaction's fairness. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (West 2011).

235. Baird & Henderson, *supra* note 28, at 1311.

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constituencies,[236] it bears radically different positive and normative implications.

From a positive perspective, the reason for allowing corporate control power to shift to NCE investors does not rest on any social responsibility argument but on the classic law and economics argument that legal rules should facilitate efficient corporate contracting.[237] In other words, NCE investors' ability to claim the exclusive loyalty of constituency directors does not follow from the attribution to the former of any special status, as progressives claim.[238] Instead, it is the product of party autonomy, i.e., the allocation of entitlements to which both shareholders and NCE investors self-interestedly agree.

From a normative perspective, the contractual underpinning of this view disentangles the attribution of corporate power from the entitlement to fiduciary claims. Modeling the director's relationship with NCE providers on the ordinary relationship with shareholders, progressives see the entitlement to fiduciary claims as a necessary complement of the attribution of corporate power. This is because, under a conceptual framework that conceives of the position of investors as beneficiaries of board actions as a legal privilege, a claim for breach of fiduciary duty will commonly be an investor's only cause of action against disloyal directors. Put another way, the attribution of corporate power to one or another type of investor would be an empty mandate absent an investor's standing to bring fiduciary claims against corporate directors.[239]

But when the attribution of power to NCE investors is re-conceptualized as the product of party autonomy, personal liability for breach of fiduciary duties is no longer a necessary ingredient to hold directors accountable. Designating investors have alternative means to mitigate the risk that constituency directors may not act in their interest,

236. The "progressive" (or "communitarian") school of corporate law is centered on the idea that corporate law should require directors to serve the interests of all corporate participants rather than just shareholders. *See, e.g.*, David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201 (defending a view of the corporation as a social institution tied to all its members by means of trust and mutual interdependence); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 630–43 (1992) (advocating that courts should extend to non-shareholders the right to sue directors); *see also* PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995).

237. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 10, at 14–15, 20–21.

238. For progressives, this special status arises from the egalitarian claim that corporate participants are equal members of the same community of interests. *See* Millon, *supra* note 213, at 1382–83.

239. *See, e.g.*, *id.* at 1388 (arguing that a multifiduciary model of directors duties is necessary to implement a communitarian model of the corporation and make the otherwise frustratingly vague directors' duty statutes effective).

whether because they engage in purely self-serving conduct or end up acting in favor of shareholders. For one thing, as long as designating investors are individuals rather than corporate entities, they may decide to directly sit on the board[240] and therefore eliminate that risk altogether.[241] Appointing constituency directors who share an ownership interest with their sponsors can achieve the identical result when the designating investors are instead corporate entities.

More generally, designating investors can, and mostly do, choose their board representatives among individuals with whom they have a significant preexisting relationship. The classical example is the appointment of constituency directors who have an employment, professional, or other preexisting relationship with their sponsors.[242] As long as appointed constituency directors place value on the continuation of their preexisting relationships with the designating investors, they will have no incentives to make corporate decisions that deviate from the investors' desired course of action. To put this in economic terms, the contract between designating investors and constituency directors tends to have relational features.[243] Hence, designating investors will generally be able to rely on self-enforcing mechanisms to constrain the risk of opportunistic behavior by their representatives. This does not exclude, however, the possibility that in some circumstances designating investors may employ specific contractual provisions to safeguard their interest vis-à-vis their board designees. What matters for the purposes of this

240. For example, this was the case of Joseph Prang, one of the directors in *Trados* and the owner of Mentor Capital Group LLC, which held one percent of Trados' preferred stock. *See In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *2 (Del. Ch. July 24, 2009).

241. One could object that actions by constituency directors who also are NCE investors could be "self-serving" in the sense described in Part III.A.1 above. Although this could be the case, this Article's proposal would still provide an effective response. Where such conduct consisted in purely self-serving behaviors (e.g., private benefits extraction), NCE investors should not benefit from the waiver of loyalty. Instead, where it consisted in the undertaking of conflict-of-interest transactions, such transactions should be considered as implicitly ratified by the NCE investors with consequential application of the waiver of loyalty.

242. In *Trados*, with the exception of Joseph Prang, all the other board designees of the preferred stockholders had either an ownership or employment relationship with their designating investors. *Trados*, 2009 WL 2225958, at *2.

243. Relational contract theory examines contractual relationships by describing parties as repeat players who take into consideration the effects of their current actions on the future actions of their counterparties. The seminal contribution on relational contract theory is owed to the legal scholar Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978). In the most recent economic elaboration of this theory, a contract is defined as relational when, for each contractual party, continuation of the contract is more valuable than her outside option. *See* Jonathan Levin, *Relational Incentive Contracts*, 93 AM. ECON. REV. 835, 839–41, 846 (2003).

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discussion is that the combination of relational and contractual levers at the disposal of designating investors makes the recourse to fiduciary claims unnecessary to preserve their corporate control.

While turning a director's loyalty obligations into a default would not extend fiduciary claims to NCE investors, it would substantially modify shareholders' fiduciary claims. For one thing, shareholders would no longer have the right to bring fiduciary claims against constituency directors. As discussed above, the only exception to this rule would concern a constituency director's self-serving conduct, which would be excluded by the waiver of loyalty.[244] However, shareholders would have the right to bring fiduciary claims against the incumbent board that negotiated the appointment of the constituency director if this action is finalized to advance the board's self-interest, rather than the shareholders' interest. While under the shield of the business judgment rule, shareholders could not challenge the merit of the incumbent board's decision, they would be entitled to prove that this action constituted a breach of the incumbents' duty of loyalty. For example, imagine that in the hypothetical from Part II.B.1, the decision of the board to opt for the refinancing strategy—and, therefore, the appointment of constituency directors—rather than the liquidation strategy was prompted by the incumbents' interest in preserving continued access to private benefits from control.[245] In this case, the shareholders would have a fiduciary claim against the incumbent board.

Additionally, shareholders would always have a course of action against constituency directors for breach of specific restrictions on the exercise of residual control in favor of designating investors. For example, if the corporate charter included a provision requiring the approval of shareholders to implement a specified transaction where a conflict of interest arose, constituency directors would be exposed to liability if they went ahead with such a transaction absent shareholder approval.

Finally, turning the obligation of loyalty into a default would also alter the scope of shareholders' fiduciary claims vis-à-vis their designated directors in boards controlled by constituency directors. Because in these circumstances corporate decision-making power would rest with the constituency directors, the fiduciary obligations of shareholder-designated

244. *See supra* Part III.A.1.

245. This is the so-called "initiation problem" of bankruptcy: the problem arising out of a manager's incentives to inefficiently delay liquidation of a company that no longer has any going-concern value out of a fear of losing private benefits of control. *See* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1239–43 (2005).

directors would essentially consist of internal monitoring functions. In other words, a shareholder's course of action against their own board designees would be substantially reduced to claims for the failure to carefully oversee the contractual restrictions that were placed on the exercise of a constituency director's residual control. Instead, in corporations with a majority of shareholder-designated directors, not much would change, since shareholder-designated directors would continue to retain decision-making power subject to ordinary fiduciary restraints.[246]

3. Feasibility

There are a number of ways in which parties could be allowed to opt out of the obligation of undivided loyalty. For example, the waiver of loyalty could be provided on a statutory level, mimicking the requirements established by Section 102(b)(7) of the Delaware Code, which allows corporations to eliminate (or limit) a director's liability for breach of the duty of care through the inclusion in the corporate charter of an exculpatory clause.[247] Similarly, corporations could be allowed to include a provision in their corporate charter to exculpate constituency directors from breach of the duty of loyalty to shareholders, with respect to both the disclosure of information to designating investors and conflicted decision-making.

As an alternative to statutory reform, the waiver of the duty of loyalty could be enforced at common law. To this end, courts should recognize a corporation's express authorization of constituency director status—whether through contract, bylaws, or corporate charter—and the waiver of loyalty implied by this status. As a practical illustration, under this Article's proposal, the court in *Trados* should have granted the preferred designees' motion to dismiss based on the waiver of the duty of undivided loyalty implied by these individuals' appointment to the board.

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246. The only relevant exception could arise in situations of conflicts of interest between the shareholders and the designating investors. In such situations, one could imagine, for example, that following the disclosure of a relevant contingency by a constituency director, the designating investors threatened to exercise a contractual discretionary power (e.g., acceleration) unless the board opted for a course of action in their favor. Under this Article's proposal, shareholder-designated directors should be exculpated from breach of loyalty where they favored the preferred shareholders to avert the latter's threat. This should hold true even where the relevant contingency was not included among those provided for by the contract as triggering the exercise of the preferred shareholders' discretionary power. Indeed, the function of constituency directors is precisely to enable the state-contingent exercise of necessarily incomplete contractual protections.

247. DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011).

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B. Undivided Loyalty as a Default

A possible objection to this Article's proposal is that the goal it pursues—eliminating inefficiencies in current fiduciary rules—could be more effectively achieved by getting rid of fiduciary duties altogether. Under this alternative proposal, all corporate directors, regardless of their affiliation with one constituency or another, would "merely be obliged to honor the terms of the firm's investment contracts . . . ."[248]

While attractive, this solution suffers from two drawbacks. First, it overlooks the fact that the rationale for making shareholders the beneficiary of a director's residual discretion through fiduciary duties—i.e., contractual incompleteness—continues to apply to the majority of corporate situations. Indeed, acknowledging the economic significance of novel business models—such as models in which contractual incompleteness issues are likely to be as severe for shareholders as for NCE investors—is not the same as arguing that these models represent the majority of corporate contexts. Instead, shareholders are still likely to be the constituency that bears the most acute contracting problems in the majority of corporate situations,[249] although the economic significance of these contexts has radically decreased.

Second, proposals for eliminating fiduciary duties from corporate law misleadingly assume that these contractual incompleteness issues could be handled through the implied obligation of good faith, as is done with ordinary contracts.[250] Under this view, the restrictions arising from the obligation to act in good faith in executing a contract would replace fiduciary restraints in preventing managers from opportunistically exploiting gaps in the shareholder corporate contract. But, while fiduciary protection is functionally similar to that offered by the contract doctrine of good faith, it is an analytical oversimplification to place them on equal

248. Baird & Henderson, *supra* note 28, at 1316.

249. This implies that shareholders remain the party who places the highest value on the attribution of fiduciary duties in the majority of corporate contexts. In these contexts, all parties are better off "if the shareholders are permitted to compensate . . . other constituencies—in the form of higher interest on bonds, higher wages to workers and managers, and better prices for suppliers and customers—for the right to have fiduciary duties flow exclusively to them." Macey, *supra* note 45, at 27. Thus, an argument exists for defending the obligation of undivided loyalty as the allocation of entitlements that corporate actors will still prefer in most corporate situations and which the law should therefore enforce as a default. *See* Eric Maskin, *On the Rationale for Penalty Default Rules*, 33 FLA. ST. U. L. REV. 557 (2006) (providing a formal explanation of why default rules should be "nonpenalty," i.e., specify outcomes that the parties *want*).

250. *See* U.C.C. § 1-203 (1990) ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.").

footing. As aptly observed by Victor Brudney, "the center of gravity of the fiduciary obligation is in the beneficiary's interests. In contrast, the center of gravity of the obligation of an arm's-length contracting party is in its own, rather than the other party's, interests."[251] Hence, on the one hand, conduct permissible under the obligation of good faith might not be acceptable under fiduciary law.[252] On the other hand, fiduciary law systematically requires agents (directors) to sacrifice their own self-interest to the benefit of principals (shareholders) unless specifically allowed to act otherwise. A similar result is not replicable in arm's-length relationships because the requirement to act in good faith is a reciprocal obligation of the contracting parties.[253] Consequently, the effects of treating fiduciary duties and the implied obligation of good faith as substitute institutions are at best normatively dubious.

CONCLUSION

A defining principle of the canonical view of corporate governance, so often repeated in academia and judicial opinions, is that shareholders alone are entitled to the loyalty of directors. Instead, the rights of NCE investors are limited to those explicitly contracted for, on the assumption that these investors, unlike shareholders, can be fully protected by contract.

This Article's analysis of the role and function of constituency directors has exposed the inefficiency of this principle in today's complex corporate environment. This principle gives only shareholders access to the residual control of directors. This limits the availability of welfare-maximizing contractual solutions that sit at the intersection of corporate and contract law. And it does so when those solutions are most needed. As this Article has shown, in some corporate contexts, such as startups and declining corporations, certain investments may be worth undertaking only where NCE investors can ensure the allegiance of directors on the board. In such contexts, allowing NCE investors to privately gain access to a director's adaptive decision-making remedies the contract's failure to provide such investors with adequate protection. Thus,

251. Brudney, *supra* note 166, at 631.

252. The classic characterization of the duty of loyalty by Justice Cardozo in *Meinhard v. Salmon* is paradigmatic of the more stringent requirements to which a fiduciary is held. Cardozo famously held that "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

253. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith . . . in its performance and its enforcement.").

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the rule that directors owe an undivided loyalty to shareholders hinders, rather than serves, shareholder interests and those of society as a whole.

Given the increasingly blurry line that separates the contracting positions of shareholders and NCE investors, the choice of who benefits from the residual control rights of directors should be left to party autonomy. Under current doctrines, however, NCE investors are only allowed to carve out specific exceptions to a director's obligation of undivided loyalty. This approach overlooks the fact that shareholders might be required to relinquish director allegiance as a whole to NCE investors in order to gain access to important sources of capital. For this reason, the obligation of undivided loyalty should be a default that corporate actors could opt out of by appointing constituency directors. This reform would eliminate the current inefficiency raised by this obligation, making the corporate pie bigger for all willing to share it.

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