CONTRACT AND TRUST IN CORPORATE LAW: THE CASE OF CORPORATE OPPORTUNITY*

BY RICHARD A. EPSTEIN**

Of Broad and English Principles. For most of my academic career I have written extensively in areas in which I neither teach nor practice. Corporate law is one of those fields that I have followed at a distance, but in which I nonetheless on occasion write. From this simple confession, two questions might be asked: first, why the Court of Chancery Historical Society should invite me to speak at its Distinguished Guest Lectureship when there are, almost by definition, a large number of gifted (if nameless) corporate scholars to whom they could have turned; and, second, why I have followed the consistent policy of straying into areas where I have no discernible expertise. I do not confess to any ability to answer the first question, although I thank Chancellor Allen and Vice-Chancellor Jacobs for inviting me to speak on this occasion, and I thank the vice-chancellor for his most gracious introduction. But I will talk directly to the second question, for the answer to it relates to the title of this talk and to my willingness to comment on what I think to be one of the central issues of corporate law: the relationship of contract and trust theory to the governance and operation of corporations. Accordingly, I shall begin my remarks at a general level and then apply them to the doctrine of corporate opportunity as developed in Chancellor Allen's instructive opinion in the difficult case of *Cellular Information Systems, Inc. v. Broz.*[1]

Over the years my dominant intellectual mission has been to use the common law categories of property, contract, tort, and (I will add) restitution to explain the larger and more complex social arrangements under which we all live.[2] My interest in this grand theme stems in part from my taste for philosophical speculation, and in part from my own educational background. I was raised originally in English law and, therefore, learned something about the ins and outs of chancery practice

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[1]663 A.2d 1180 (Del. Ch. 1995).

[2]On which, see generally, RICHARD A. EPSTEIN, SIMPLE RULES FOR A COMPLEX WORLD (1995) (explaining how adherence to these basic principles of the law can aid people in organizing their affairs within a convoluted social fabric).

in the nation that gave birth to the systematic distinction between law and equity, and which still lends greater recognition to those differences in its day-to-day operations. In addition, the standard English model of legal education, at least when I was a student at Oxford, was organized around a few fundamental categories, each of which contained a very large portion of legal territory. The balkanization of the curriculum, which is in part a consequence of the course system in the United States, had not (at least as of thirty years ago) run its course in England. I was, therefore, accustomed to treating torts as covering everything from a punch in the nose to a trade dispute between rival firms, or to a struggle between employers and their unionized workers. Contracts, for its part, covered everything from the niceties of offer and acceptance for the sale of a loaf of bread to contracts for the purchase and sale of world-wide corporate businesses. That comprehensive view of the legal universe reveals no obvious fault-line between public and private disputes, or even between big and little ones. There is simply a relatively small body of cohesive legal principles — promise, harm, interest, causation, benefit — that in various combinations apply over and over again to a wide variety of situations that look less diverse once their intellectual origins are well understood.

The second reason why I believe in the intrinsic unity of the law dates from my own foray into constitutional law — another area that I do not teach — culminating in my book *Takings: Private Property and the Power of Eminent Domain* (1985). There I argued in a most contrarian manner that the bedrock common law relationships between private individuals form the indispensable foundation for understanding the proper sphere of government regulation in the modern age, whether or not compensation is offered. The law of property, tort, contract, and restitution offer in my view the *only* coherent way in which to understand the legitimate scope and limits of constitutional power by which to make sense of our own constitutional order. After all, how can one make sense of a clause that speaks of "impairing the Obligation of Contracts"[3] without knowing what constitutes a contract, or find out what is the proper scope of the police power unless one can give a coherent account to the private law of nuisance? As recent decisions seek to grapple more conscientiously with the scope of government power, the role of these concepts in public debate grows larger. It is only when the severance of public law from its common law roots is complete that the modern state can acquire its huge repository of power.

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[3]U.S. CONST. art. I, § 10, cl. 1.

The External and Internal Lives of the Corporation. The same difficulties I think complicate the proper analysis of corporate law, for corporations often lie at the intersection of public and private law. Thus, it is often said that a corporation is a creature of the state that grants it a charter and offers it the protection of limited liability from general creditors. The power in question is said to justify imposing restrictions on corporate operations. As that is the case, the intimate connection between public and private law in the corporate context should be apparent.

The issue becomes even more sharply focused when it is realized that most of a corporation's affairs can be divided into two large categories: the first of these deals with the external relationships of the corporation to the rest of the world; and the second deals with the internal affairs of the corporation, i.e., the way in which the corporate participants — shareholders, directors, officers, and perhaps bondholders and contractual creditors — organize their cooperative venture among themselves within the capacious mantle of limited liability that guards against outside attack unless waived explicitly by agreement.

There is little doubt in my mind that the membership and the form of the corporate community is heavily shaped by the presence of limited liability. After all, it is this doctrine that allows people to enter and exit corporate ventures without having to run the risks of being held vicariously responsible for the actions of their servants, the corporate officers. But here I plan to ignore the fruitful discussion of interactive effect, because, in this talk at least, I wish to concentrate on the question of internal relationships defining how the various members of the corporate community organize their lives among themselves. Not surprisingly, it is just at this juncture that the law of contract moves to center stage; for the first, naive, and indeed correct answer to this question is that the internal affairs of the corporation are — or more accurately, should be — settled by contracts among its members. But to that answer there comes the next question: if this were all that there was to the law of corporations, then we could not distinguish between a contract for the sale of bread from a contract to form a corporation to make communications software. After all, if a contract's terms are strictly and solely a matter for determination between the parties, why bother to distinguish between these two types of deals in the first place? Why, in other words, have a separate body of corporate law at all? Indeed, why have a court of chancery dedicated to dealing with corporations in equity? Indeed, why have this lecture?

Relational and Spot Transactions. The answer to the above challenge cannot be found in the law of offer and acceptance, in the law

of consideration, in the law of fraud, conditions, or frustration or mistake or impossibility, for each of these areas of law applies in its own way to the routine sale as well as to complex corporations. Just because a transaction involves only a few dollars does not mean that it is easy to disentangle all the blunders, mistakes, duplicity, and misfortune that go into creating a delicious legal mess. The answer, therefore, has to lie elsewhere; and it lies in the nature of the transaction as perceived by the parties to that relationship.

The first great divide is between relational and spot transactions. By spot transactions, I mean those that contemplate a transfer of title or the performance of a discrete bundle of services which can be performed in a compact span of time. In contracts such as these, each party desires to possess what the other owns, and each is prepared to part with what he owns in order to obtain it. Generally speaking, the cleaner and quicker the deal, the happier and wealthier its participants. The normal sale of a house does not contemplate a period of years when the buyer and seller share the premises. And, if it does contemplate a mortgage to purchase the property, the prompt payment of the monthly bill keeps the two parties securely fastened on their separate courses. Each one, in effect, wishes to conduct his own affairs with the same independence after the transaction was entered into as before, and the contract provisions are typically drawn to preserve for both the requisite degree of independence before and during the transaction. In the limiting case, one has a cash sale in which the near instantaneous transfer of assets marks the successful completion of a transaction that offers mutual gain to both parties.

The mortgage example, however, shows that a second divide is needed in order to complete the analysis. It is simply not sufficient for understanding corporate transactions to rely exclusively on the key distinction between spot and relational transactions. To be sure, a corporate deal is not a spot transaction, but, by the same token, it cannot be said that all relational transactions are typical or corporate or, to edge closer to our subject, trust relationships. Thus, so long as the mortgage is not in arrears, the relationship between the parties is judged by strict legal rules that permit no degree of advantage taking by either side. Indeed, one reason why mortgages are typically assignable and often assumable is that the personal identity of the parties is of no consequence when prompt mailing of a monthly check prevents the triggering of any and all other obligations. The usual calculations on mortgages do not deal with governance questions or fiduciary responsibilities. Typically, they are concerned with packaging of financial incidents — prepayments to avoid high interest rates and the like.

Once, however, the arrangement falls into default, then an element of trust comes into play because an element of discretion necessarily comes into the picture. Someone has to decide whether possession of the property moves from borrower to lender; someone has to organize the sale and decide whether to take an early bid for less or to hold out for more; someone has to resolve conflicts of interest between the mortgagor and mortgagee. So, here we move closer to a fiduciary duty. Yet, for two reasons we have not quite reached the limit of the pure fiduciary case of importance in the corporate context. First, it is clear that mortgage foreclosure does not contemplate a long-term relationship between the parties, save by necessity. The object of the game is still to disentangle the interests as quickly as possible so that both parties can go their separate ways. Second, the lender has no duty of loyalty that requires it to put the interests of the borrower first. To be sure, the borrower's welfare counts, but only after the lender has been able to collect principal, interests, and costs.

The Consensual Origins of the Trust Relationship.[4] It is this last element that distinguishes the foreclosure situation from the trust relationship arising in the corporate context. Discretion that affects the welfare of another individual is not quite what is needed to make a trust. What is needed is an additional element: the beneficiary of the arrangement is conceived of as largely passive (until required to sue to protect his own rights), and the party bearing the trust has to exercise discretion in a way that works to the exclusive advantage of the holders of the beneficial interest. Accordingly, in the cleanest of all situations, the trustee's sole compensation comes from either a fixed payment or some other compensation formula (e.g., a fee based on performance of a stock fund). Unlike the mortgage situation, the trustee is normally required to put the beneficiary first; in some cases, he cannot even put himself second. The issues that arise around this conception are two. The first asks, how does this particular duty arise? The second asks, how is the duty carried out in particular circumstances?

Trust and Consent. Turning to the first issue, it seems clear that the dominant category of analysis should be that of consent. In most cases of corporate formation, there is little concern about the welfare of third parties: corporations are not organized to bomb innocent individuals, and the competitive harm that they inflict on their rivals is the necessary price to advance first consumer and then overall social

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[4]On which see, John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995) (viewing its contractarian character as the defining aspect of the trust relationship).

welfare. Similarly, the usual problems of formation that deal with incompetence, fraud, nondisclosure, and the like can be handled by standard contract doctrines that apply to formation without going to the question of what kinds of terms these parties want. The basic insight, which bears constant repetition, is that the corporate arrangement, like all other voluntary arrangements, has to satisfy the usual contractual condition: the deal has to work *ex ante* for the mutual benefit of the parties. The challenge, therefore, is to figure out how the usual concept of fiduciary duty fits within this overall account of joint contractual egotism.

One way to see the transition is to note one path for the formation of corporations and other forms of associations. Earlier I noted that the simple form of spot transaction was the ordinary conveyance in which the risk of ownership was exchanged for cash in transactions calculated to allow both parties to operate independently on closing. But, a much more complicated transaction is one in which a *partial* interest in a particular property is sold by "A" to "B," and A retains the interest that is not sold. Here the details of differences between joint tenancies and tenancies in common are not of concern. Rather, central to the inquiry is how do two equal partners share in the management of their common property. Rules that are as specific as those which govern the payment of a mortgage may form part of the overall plan. Yet, these usually will not be sufficient, given the unforeseeable contingencies to which the parties will have to respond. At some point concrete rules will have to give way, or at least share the stage, with other rules of a more general and diffuse nature.

Here, the good news is that it is possible to give an abstract answer for the dilemma posed by divided control. The bad news is it is not possible to apply that rule with the same rigor with which it is announced. The grand generalization is this: each part owner of the property has to make decisions as if he were the owner of the entire property. The point of the rule is to ask each person to treat the welfare of the other as having equal dignity with his own; for if that rule is followed, then the two part owners will have effectively neutralized the conflicts of interests that come between them.

Yet, even if that rule is followed, it cannot bring about a perfect concordance of wills. It may well happen that A, as sole owner, would make a different decision with respect to the property than B, and that both would be acting in good faith although they chose to make different decisions with respect to the interests of their common venture. The differences in outcome may stem from different estimations as to the likely consequences of alternative decisions, the way in which the

treatment of a single piece of property ties in with the overall portfolio of assets possessed by each partner, or differing attitudes toward risk depending on, for example, age or wealth. The fundamental norm is at best a test, albeit a powerful one, that allows a court to rule out some decisions of a joint owner on the grounds that they are not compatible with his obligation as a joint owner. But the test cannot eliminate honest divisions of opinion between the two parties.

So, what then is done in these cases? Explicit contracts often require the element of good faith and then refuse to impose further restrictions that cannot be sensibly enforced by extra judicial proceedings. In essence, the parties know — or will quickly come to know — that their best protection against the inconsistencies of tastes and temperament lies in their ability to *select* co-owners whose tastes and attitudes are compatible with their own. It becomes pointless to try to find or draft any form of language to do the impossible. The margin on which most movement should take place is in the selection of partners and not the selection of contract terms. Most people know this. They pick the partners first and worry about the contract later, not the other way around.

Thus far, the analysis of the move from conveyance to governance has confined its attention to the two party transaction. It is important, however, not to neglect the most salient feature of this relationship. In cases of honest conflict, there is not a wide choice of decision rules: a default rule for ties is surely needed unless and until one party is given a majority interest in the business. In principle, people can arbitrate their disputes, but resorting to that method is a way of winding up business, not of conducting an ongoing relationship. So, once again, the best way to avoid stalemate is by picking a partner who is likely to agree with your views and to hope that changed circumstances do not alter that estimation for the worse.

Many corporations, however, involve conveyances by three or more individuals to a common venture. In this setting, the problem of joint control can be resolved in ways that are not usually available to the ordinary two person partnership. Thus, one key decision is to say that only a *subset* of the joint venturers will make the decisions about the ongoing control and use of corporate assets. This ostensible departure from the democratic ideal of "one man, one vote" strikes me as a wise decision because it reduces the information burdens on the passive contributor to the venture. As a shareholder or limited partner, I know I need to focus only on the decisional capabilities and preferences of the set of probable directors and officers. By the same token, I know I do not have to worry about the abilities and tastes of the large number of

nameless shareholders in whom I would place no confidence and who, if asked, would surely return the compliment. They would want me out of the management picture, just as I would want them out. Passivity is a reciprocal relationship with important, if hidden, virtues.

But what about those individuals who do take active control positions? What kinds of duties do I want to place on these managers, and what kinds of obligations are they prepared to assume? Well, the problems of foresight over the future are not eliminated because the venture is more complicated than before. Hence, the subtle transformation from conveyance to contract (e.g., from sale of property to contribution to joint venture) that marks the shift from conveyance to partnership carries over to these more complicated corporate settings. And with that transformation, the same pair of ambiguities surfaces once again. On the one hand, I would like the managers of the business to take into account my welfare, just as I would for myself. Since they are paid for their services, I would not want them to maximize their own benefit from the business, save to the extent that they also occupied a shareholder role. So, the duty of loyalty seems to me to be a very accurate implication from the realities of corporate life.

So too does the duty of diligence. People are paid to exercise good care, not to be negligent. There could well be some question as to what sanctions are applied in dealing with breaches of these duties. Just to state the question is to show how difficult it is to resolve it. If the consequences of breach are made too high, good people will shun the job unless they receive more compensation than sensible shareholders want to pay. If the duty is made too lax, the performance levels of the managers will deteriorate. So we know that we can be too tough or too lenient. Thus, we cannot state where the optimal level lies, leaving us to use such words as "good faith" and "reasonable" to indicate our faith in that optimum middle point whose existence is abstractly known but whose place cannot be specifically defined.

It is of just such humble and recurrent considerations that the entire fabric of fiduciary duties is borne and continues to hold such salience today. And, here, if one looks at explicit contracts, they may be quite precise on matters of detail; but, in the end, the limits imposed by the problem are unable to eliminate the irreducible slippage between general principle and the concrete case. So long as a contract term contains the words "good faith" or "reasonable," it cannot be regarded as falling in a different universe from a default provision that relies on the same terminology.

So, the good news and the bad news come together in an instructive way. The good news indicates that we should search for that

optimal middle path. The bad news is that we will never be able to set out its contours in indelible ink. It is all a matter of approximation from easy to hard cases in a world in which the difference between express terms and default provisions is less significant than it is in other cases, such as setting the price in a contract of sale. In saying this, I do not mean to suggest that contracts cannot be improved to reflect or repudiate judicial decisions. In fact, the corporate bar is stunningly astute in developing contractual language to protect against various forms of difficulty that do arise. For instance, think of the speed at which covenants were formulated to protect bondholders against loss in value in the course of mergers and takeovers. The recognition that some residual uncertainty exists does not mean that its scope cannot be reduced by careful drafting. Oftentimes, it depends on how late in the day we are forced to resort to conceptions of reasonableness and good faith. But, it hardly follows that these terms should be the exclusive tools of analysis just because they are at times indispensable tools of decision.

Is the Duty of Loyalty Waivable: The Case of Corporate Opportunity. Thus far I have not raised any unduly controversial weaknesses. But one key question looms around the corner. The duty of loyalty is borne of contract and consent. But, are its terms so important that they are included in each and every corporate arrangement, or are the terms subject to variation by the agreement with the parties? It is commonly understood that duties of care can be altered by agreement with directors and managers. But, there is far greater reluctance to make any duty of loyalty waivable in similar fashion. Instead, it is widely assumed in many states that the duty simply goes with the territory. Once individuals have assumed a corporate office, they cannot disclaim by separate covenant or agreement the obligation of loyalty to the firm.

In my view, this position is mistaken or at least overstated. To be sure, there are very few occasions where shareholders would consent to the appointment of a director where the contract allows looting of corporate assets for private gain. The shareholder/director relationship has to satisfy the mutual gain condition of all contracts, and it hardly looks as though the looting contract meets that specification. Hence, it is easy to develop an ideal of nonwaivable or categorical duties in settings where no market or business considerations push in the opposite direction. But, it may well be a mistake to assume that all duties of loyalty should have this nonwaivable characteristic. In order to show why even the duty of loyalty should be regarded as a default obligation, it is useful to consider one class of decisions of great importance in this regard: the case of corporate opportunity.

The doctrine of corporate opportunity is a standard part of corporate law in and out of Delaware. At its most general level, it says that a director or an officer of a corporation cannot divert to himself opportunities directed to the corporation. The basic instinct is that certain opportunities should be treated as though they were the property of the corporation and that any decision by an officer or director to convert the corporate opportunity to a private one should be treated like a misappropriation of corporate assets. And if there is no reason to allow looting of the corporation, then the prohibition against converting a corporate opportunity makes good sense, not only as a default provision, but also as an absolute that cannot be varied by agreement.

The Prior Case Law. To set the stage for the analysis, it is useful to begin with several early cases. First, in *Lagarde v. Anniston Lime & Stone Co.*,[5] a corporation had a one-third interest in a limestone quarry, an option to acquire a second third, and the possibility that it just might purchase the last third. Certain directors and shareholders, however, purchased the last two pieces of the mine. Their actions were held to violate the corporate opportunity rule with respect to the second piece but not the third piece. The first part of the decision seems correct. Indeed, one does not need an explicit doctrine of corporate law to respond to what appears to be an interference with a preexisting contract. But, the court held that the mere expectation for the last piece did not count because it was not borne of contract.

That result seems wrong as a matter of first principle. Here, there is not simply competition for resources between the corporation and the directors, but competition for resources that have clear synergies with properties already owned and possessed by the corporation. Stated simply, the operation of the mine can surely take place far more effectively under a single owner. Perhaps an outsider could frustrate that plan by seeking to acquire the third piece, but it is highly unlikely that a corporate director should be given that slack.

Once a director completes such a purchase, he then occupies a position that is, at least in part, adverse to that of the corporation. As he seeks to gain a larger share of the common venture, he will be armed in any negotiations with knowledge that he has about the internal operations of the corporation. That knowledge could prove of immense assistance in negotiating over the operation of the mine or the divisions of the spoils. Within a contractual framework, the total gains for the

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[5] 28 So. 199 (Ala. 1900).

corporation and the directors seem smaller with that divided authority than without it.

Otherwise stated, if the question is whether the gain to the director from independently acquiring the last third interest in the mine is greater than the gain to the corporation from unified management, then the answer seems an unequivocal no. Corporate ownership avoids the coordination problem at the back end and the possible misuse of corporate information for private purposes. A director should, therefore, be expected to waive his rights to acquire that interest even in a world where the doctrine of corporate opportunity is not treated as a fixed and invariable part of the legal universe.

In similar fashion, it seems virtually automatic to say that a corporate director could not acquire, for example, the landlord's interest in any lease where the corporation is a tenant. It is too much to require the corporation to negotiate with one of its own. Whether one thinks of corporate opportunity as a doctrine of contract or trust law, the outcome in this class of cases seems to be pretty much the same. It would take a powerful contractual agreement to reverse this understanding.

Second on my list of cases is *Guth v. Loft, Inc.*,[6] which arose when the president of a beverage company acquired for himself the formula and trademark of the bankrupt National Pepsi Cola Corporation and, in fact, sold some of its output to his employer. *Guth* did not raise an obvious coordination problem — that is, Guth's ownership of the second business did not create divided ownership of a common asset between him and his corporation. But, the bankrupt corporation was in the same line of business and, in fact, transacted with Loft. Now the information strand of the earlier cases comes to the fore, because it seems quite likely that Guth's decision to buy National Pepsi Cola and market its output depended in some measure on the knowledge of the market that he acquired as president of Loft. In addition, the ability to acquire National Pepsi Cola for his own account would surely skew Guth's judgment on whether it would be appropriate for Loft to acquire a firm that was in or near its core business. Guth's job was to maximize the value of the company of which he was president, and he could not do that well if he had a side venture that operated in the same general domain. From an *ex ante* perspective, there seems little doubt that the corporation could have and would have asked him not to enter this side venture. So, once again, in the absence of an express contract to the contrary, the decision seems correct, and it remains a landmark in the modern law.

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[6] 5 A.2d 503 (Del. 1939).

My third preliminary case comes out the other way. In *Burg v. Horn*,[7] the Horns had already been involved in the purchase and operation of low rent buildings. They urged their friends, the Burgs, to invest with them and, toward that end, the two families formed a corporation that acquired several buildings on their behalf. All the while, the Horns continued to acquire and manage other properties on their own account.

Here, the court held that no duty of loyalty was breached, and its decision was correct. To be sure, any of the new ventures could have gone into the corporation that was jointly owned by the two families, but by the same token it was known at the outset that the Horns had already developed several properties on their own. In that setting, it is most unlikely that the Horns would agree to sacrifice their independence in all future ventures simply because they opened one good venture prospect to a friend. And, to announce a rule in advance that they *had* to abandon their separate ventures would have been one sure way to keep the Burgs out of real estate altogether. I have no doubt that the Horns did oblige themselves to devote sufficient time and attention to the ventures under common ownership. But, it seems highly unlikely that they agreed to make the Burgs lifetime partners. Their differences in taste and attitude, as well as their different levels of wealth, make it highly unlikely that all deals were equally suitable for both families. After the fact, it is clear that the Burgs had every incentive to announce their eagerness to participate in ventures that have proved successful. But *ex ante*, the understandings were likely to be quite closer to the Horns' version of events.

So, how does one understand this case? One approach is to insist that closed corporations and public corporations operate differently as a matter of law. Just that approach is mentioned by Dean Clark in his text, *Corporate Law*.[8] In it, Clark develops distinctions between public and private corporations that make it far more likely that close corporations will tolerate the relaxation of the corporate opportunity rules. His basic argument is that it is far easier to customize deals in private corporations and that these deals normally allow individuals greater freedom to pursue independent ventures. He, therefore, proposes that the doctrine of corporate opportunity be *categorical* with respect to public corporations and *selective* to close corporations. At no point, however, does he discuss the possibility that the duty of loyalty itself could be waivable. Rather, he seeks to account for the variation between cases within a

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[7]380 F.2d 897 (2d Cir. 1967).

[8]ROBERT C. CLARK, CORPORATE LAW § 7.3 (1986) (building upon Victor Brudney & Robert C. Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981)).

common legal category — directors and corporations — by redefining the scope of a rule whose mandatory nature is, if only implicitly, accepted.

I agree with his basic attitude toward the close/public distinction, but would rephrase the analysis to say that the default rule which imposes broad restrictions on the uses of corporate opportunities should be reversed because it does not *ex ante* maximize the joint interests of the parties in close corporations. But since *Burg v. Horn* strikes me as a common situation for energetic small businesses, I would not expect the problem to be resolved mainly by abstract principles of law. Since most successful individuals can stoke more than one fire at a given time, we should expect to see *express* provisions that allow directors and officers to engage in parallel adventures on their own.

I can recall that when I was brave enough to invest in private limited partnerships in the late 1960s, the standard agreement contained a waiver of the corporate opportunity doctrine allowing the general partners to invest in other deals with whatever information they came by. I signed those deals after a bit of thought because I knew that the general partners were already in lots of deals and that it would be quite impossible for them to figure out what bit of useful information came to them in what capacity. I also knew that the capital invested by the limited partners for this venture would be used fully in the development at hand, so that any new opportunity would require fresh financing. My gamble was that if I were interested in a new deal, the general partners would come knocking at my door, although I knew that other partners in other ventures might be asked first for reasons of friendship, experience, wealth, connections, or other considerations. But, I was prepared to take a business risk on this matter, and I never troubled to ask myself whether it was allowable for general partners to waive the duty of loyalty. My concern was not with the control of new information. It was with the dedication of sufficient time to make this venture a success, even if it were in competition with others that were under the management of the same general partners. Even at a young age, I was prepared to live with a certain level of ambiguity. It is in just this connection that the contractual view of the duty of loyalty seems preferable to the trust view of that doctrine.

Cellular Information Systems, Inc. v. Broz. Let me now turn to the recent opinion issued by the Delaware Court of Chancery in what bodes well to become a leading decision on the subject: *Cellular Information Systems v. Broz.*[9] In a nutshell, CIS started life as a firm specializing in

[9]663 A.2d 1180 (Del. Ch. 1995).

the acquisition and operation of cellular telecommunications systems under FCC licenses in the upper midwest, chiefly in Wisconsin and Minnesota.[10] Broz was one of its outside directors who also ran his own company, RFB, which operated in the same line of business.[11] RFB held key cellular licenses also located in the upper midwest, mainly in Michigan.[12] A third company, Mackinac Cellular Corporation, owned a valuable license for a Rural Service Area (RSA) situated midway between these two systems on the Eastern tip of Michigan's upper peninsula.[13]

Mackinac was interested in selling this license to the highest bidder. To this end, it retained the services of a broker, one Rhodes, who approached Broz and his corporation in early 1994, presenting him with a confidential packet about the station.[14] At that time, CIS was in no position to negotiate the purchase of any assets.[15] It had just emerged from a thankless and bitter bankruptcy struggle and was in the process of liquidating its assets.[16] Mackinac did not consider it a rival, and neither did Broz. For the remainder of the spring, there was some negotiation between Broz and Mackinac, but no deal was reached.[17]

In the second half of 1994, the situation changed. While Broz continued to negotiate with Mackinac, CIS was approached by another company, PriCellular, which was also in the business of acquiring licenses in the upper midwest to operate together with its existing franchises.[18] PriCellular eventually negotiated a deal whereby it purchased the clear majority of shares (and through it most of the assets) of CIS.[19] Concluding those negotiations reversed CIS's desire to unload its own assets.[20] Key to this case, PriCellular also had entered into an option contract with Mackinac for the purchase of its license at $6.7 million.[21] That option contained an escape clause for Mackinac, which became operative if it could obtain an offer in excess of $7.2 before midnight November 15, 1994.[22] Broz eventually agreed to pay that price

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[10]*Id.* at 1182.
[11]*Id.* at 1183.
[12]*Id.*
[13]*Broz*, 663 A.2d at 1182-83.
[14]*Id.* at 1184.
[15]*Id.* at 1182.
[16]*Id.*
[17]*Broz*, 663 A.2d at 1184.
[18]*Id.* at 1182-83.
[19]*Id.*
[20]*See id.* at 1183-84.
[21]*Broz*, 663 A.2d at 1184.
[22]*Id.*

on behalf of his own corporation.[23] As a consequence, all three parties ended up in court. The key question was whether the doctrine of corporate opportunity precluded Broz from making this deal, when (1) Mackinac's offer did not come to Broz through CIS and (2) the harm to CIS stemmed solely from its contract with PriCellular which was entered into only after Broz began negotiations with Mackinac, but which agreement was under active negotiation before the PriCellular-Mackinac option expired.

The chancellor split the difference. For the first portion of his opinion, he argued that the scope of the fiduciary duty in the corporate opportunity area meant that Broz behaved improperly by proceeding without notifying the board and without receiving its consent. His decision, thus, breaks some new ground in the law of fiduciary duties. The question is how well the decision stacks up against the basic principles set out above.

The chancellor's original point of departure is one that we can generally accept: the doctrine of corporate opportunity clearly applies when an officer or director of a corporation receives information in the course of his corporate business which is then turned to his private use. But at the outset, the chancellor's opinion obscures the question of whether this doctrine has its origins in the law of contract or whether, as part of the duty of loyalty, it comes as a nonwaivable command of the positive law. We are told:

> It is basic that service as a director of a corporation entails the voluntary assumption of a duty of loyalty to the corporation, and in some instances to the shareholders directly. Broadly speaking this duty prevents or remedies conduct in which a corporate officer or director uses her power with respect to corporate processes, or property, or her access to confidential corporate information, to advantage herself in a transaction that is not entirely fair to the corporation. . . . The classic corporate opportunity cases involve instances in which officers or directors use for personal advantage information that comes to them in their corporate capacity, by diverting a profitable transaction from the corporation. Such cases are simply a form of misappropriation, not conceptually dissimilar from general torts of that description.[24]

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[23] *Id.*

[24] *Id.* at 1184 (citations omitted).

This passage gives rise to several observations. The opening sentence reads quite well without the "voluntary" before "assumption of duty."[25] Thus, it appears that the chancellor treats the duty as nonwaivable, in part, because he cannot conceive of a set of circumstances where rational parties would think themselves better off *ex ante* by waiving the duty of loyalty and allowing officers to take opportunities that might prove advantageous to the corporation. But, there is some question as to the scope of the duty even in those cases where the officer or director acquires the information in the course of corporate duties. Thus, the breach of the duty is said to arise when the "corporate officer or director uses her power with respect to corporate processes, [etc.] in a transaction that is not entirely fair to the corporation."[26] The strongest case is one where the information in question allows the director to obtain some advantage in a *transaction with* the corporation, as in *Lagarde v. Anniston Lime & Stone Co.*[27] But, a further question is whether the information can be used in *competition with* the corporation to allow the insider to bid against the firm.

The rationale for that prohibition seems, in general, quite clear in light of *Guth*. The information generated within the corporation is for its purposes. The compensation given to the director or officer usually comes in the form of stock or cash. Why allow that insider to take the information and use it to raise the cost of doing corporate business? It does seem intolerable that information generated by the corporation could be used against the corporation, blunting the candor and openness needed for collective deliberation. By way of analogy, the usual rules of engagement provide explicitly that lawyers cannot use confidential information to trade on corporate stock: a voluntary version of the insider trading rule.

It, therefore, seems as though the chancellor is correct about the basic corporate opportunity case. The blend between the inevitable voluntary duty and the mandatory duty seems small enough. There is a good reason for the stated ambiguity; for it is unlikely that any divergence will take place between what the law requires under the trust conception and what the parties want under the contract conception. In the cases stated above, it looks as though the gains to the corporation from imposing the duty exceed the losses to the director from obeying it. The transaction seems to meet the requirements of mutual gain.

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[25] *Id.*
[26] *Id.*
[27] 28 So. 199 (Ala. 1900).

In this case, however, there was no misappropriation of information derived from the corporation. Recall that Broz got his information from an impeccable and disinterested source: the broker for Mackinac who wanted to maximize the price received for the sale of the cellular license. He determined that Broz was an ideal candidate to complete the transaction. Does this mean that one should assume that directors have a duty to *give* to the corporation information that they receive from outside sources? And, if they have to give the information, can they also keep it to make use of it for their own benefit? Remember, information is not like a barrel of wheat: a party can both give it away and keep it. The value of what is retained is a function of what is given. So, assuming that some duty exists, which way does it cut? Here we know the preliminary answer of the chancellor, as indicated in the passage quoted above: the wrong committed by Broz was both the failure to give notice — which allows the corporation to use the information — *and* the failure to obtain the consent of the corporation to go forward with the information already possessed — which debars his use of the information so obtained.

So, the possibilities that have to be addressed here are threefold: first, the director can use the information like any private information; second, he has to share the information; and third, he has to surrender the information to the corporation and cannot use it himself. How does the usual contractual assumption deal with this situation? A reflexive invocation of the principle of loyalty might suggest that surrender is the only answer. But, why should that be the case? Here again, *Burg v. Horn*[28] is suggestive. Many successful business types have all sorts of multiple ventures and cannot give exclusive loyalty to any of them. Here one could argue that the correct position in the case was that taken by Broz: I can use information that comes to me in my private capacity for my own benefit and, it must be recalled, for the benefit of any shareholders of RFB Corporation to whom I also owe fiduciary duties.

Should the scope of his duty depend on whether these persons do exist or whether he was a sole shareholder? If anything, it looks as though the broker did not expect him to relay the information to others. He certainly would not spend the time filling Broz in on the details of the offer, if he thought that Broz was powerless to respond to it, unless and until obtaining the consent of CIS and/or PriCellular. So, we have yet another wrinkle: if the corporate opportunity comes packaged by an

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[28]380 F.2d 897 (2d Cir. 1967).

independent third party as a private opportunity, then why must it be turned over exclusively to the other side?

Another route leads to this same conclusion. Let us suppose that Broz wanted to keep the transaction in the dark: would it remain that way? Well, no. The person who has the key information about this deal is the broker who wants to make a market. He has no obligation to Broz not to communicate the circumstances of sale to CIS or to PriCellular. In fact, that last feature makes the case even clearer. PriCellular had purchased a partial lock on the deal: it retained exclusive rights to the transaction unless Mackinac could find someone who will top its bid by $500,000. Now suppose that the superior bid comes and the option cannot be exercised. It hardly follows that PriCellular is out of the picture. The clever broker is not under a duty to accept that higher offer. He can treat it as a baseline for a fresh bidding and allow the chastened PriCellular back into the competition. That can happen without Broz doing anything in the situation. It only takes one phone call to reestablish a stratospheric auction.

This possibility should give us some information about at least one of our alternatives: is the duty that Broz has to CIS (and PriCellular) one to communicate? In this situation, the answer seems to be no. Mackinac can handle that part of the transaction by itself. So what about the other alternative: requiring Broz to get consent to participate? Here one sees real complications. It looks as though the doctrine of corporate opportunity is now being used to suppress an auction that the third party wishes to create and to impose real limitations on the freedom of Broz. When he signed on as a director, knowing that he had other opportunities, did he agree to so limit his activities that he had to put another corporation first? And, did Broz assume the obligation to take into account the interests of an *acquiring* corporation whose concerns extended beyond those of CIS when he signed on? It does not seem so, at least to me. What reason is there to believe that this restriction maximizes the joint value from the *ex ante* perspective?

So, our evaluation brings the transaction around to the remedy that is warranted. CIS lost out to Broz. Now, one possibility is to say that, if consent was required to enter, then the proper remedy was to force the resale of the interest in question for $6.7 million. After all, the damage that was done to PriCellular was the loss of the option to purchase at that value. We are simply using the corporate opportunity doctrine to restore PriCellular to its former happy place. So, Broz loses the $500,000 he invested to top the earlier bid. But, the chancellor did not take that position. Rather, he held that all CIS could insist on was the transfer from Broz of his right to purchase the license, forcing CIS to pay the full

purchase price — i.e., forgo the benefit of its earlier option. That position only makes sense if the corporate opportunity doctrine requires only notice, but not consent of CIS — a position inconsistent with the basic thrust of the underlying duty of loyalty. What view of the corporate opportunity doctrine makes it permissible for Broz to enter into a spirited competition with CIS which would have to best his offer to acquire the property? Loyalty seems to preclude competition.

If the duty of loyalty has nonwaivable teeth, then Broz's obligation should have been to obtain consent to bid. Since that consent was not obtained, damages should accrue for the full excess, at least if no other party was prepared to enter the bidding at $7.2 million. After all, if Broz had not bid, then PriCellular's lock on the deal would have been firm. So it looks as though we can detect some manifest incongruity between the remedy chosen and the ostensible nature of the underlying duty.

That disjunction, in turn, should lead us to return to the basic question of law, which is whether the corporate opportunity doctrine applies in this case. As I noted before, I think that this question has to be answered from the *ex ante* perspective. Thus, the question immediately must be asked: how far back in time do we have to go to resolve the issue? My own inclination is to return to the moment that Broz signed on as a director of CIS. If at that time he was engaged in running his own cellular enterprises (whether or not in the form of RFB), then I think that the answer is clear. To take a leaf from Brudney and Clark, it is highly unlikely that any categorical duty should be imposed on an outside director of a close corporation to forgo all other business opportunities. It follows, first, that the duty should not be categorical, and, second (though less clearly), that the original default position should be set to allow Broz to pursue separate ventures. Although it is possible to take the middle position, that the corporate opportunity doctrine sets up a presumption in favor of loyalty that can be waived only by a clear expression of intention, I don't think that this position captures the basic realities as set out in *Burg v. Horn*.[29]

But let us suppose that this is wrong. There is still the question of when the duty of loyalty attaches. Here the best approach measures the scope of the duty at the time that the external offer was made. In this case, that event occurred in early 1994, when CIS was not in the business of acquiring FCC licenses. If, as of at that time, Broz had changed his position in reliance on his understanding that CIS was not in the picture, then I think he was entitled to go forward with his negotiations even after

[29]380 F.2d 897 (2d Cir. 1967).

PriCellular comes into the picture. The position here is little different from the ordinary view of detrimental reliance. At the very least, Broz seems to be entitled to recoup all his costs incurred in reliance on CIS's indifference to the transaction prior to the time that he came under any obligation to withdraw from the negotiation. But, the complexity of deciding when the situation changes and what cash obligations arise from the reliance render this position a distinct second best alternative. The simpler solution seems better: once CIS is out of the picture, then Broz can press on to the successful acquisition.

The overview of the possibilities in a particular transaction tells us something about the use and limits of the two methods. Treating the corporate opportunity doctrine as one based on nonwaivable trust principles has the advantage of certainty, but, in the case of outside directors of a close corporation, it has, in my view, the greater weakness of rigidity. The rule does not seem to fit with the basic business realities of the situation. Yet, once that fixed position is abandoned, it is no simple matter to figure out exactly what the rights and duties are when engaged in that formidable task of hypothetical reconstruction of contracting alternatives from the *ex ante* perspective. Indeed, it is not always clear how far back one has to go in order to achieve that exalted *ex ante* status. So, in all these cases some degree of uncertainty will creep into the proceedings; for it is easier to state the applicable principles of joint maximization than it is to apply them.

Corporate opportunities arise in so many diverse circumstances that it fairly invites interpretative difficulties when the terms of the relationship of the director or officer vis-à-vis the corporation are not set out in advance. This definition of the problem does not offer some neatly packaged conclusion, but provides a set of shifting presumptions that depend on the source of the information (inside or outside) and the opportunities that the director is asked to sacrifice to serve the corporate interest. The idea of a fiduciary duty is surely plastic at the edges, as this extended discussion of *CIS* reveals. But, I do not believe that it should be regarded as infinitely expandable. Nor does it follow that courts must always fill in the gap; for, at least in cases dealing with the other business ventures of outside directors, some express drafting should go a long way to clarify the relationship before difficult cases arise. Yet, it is precisely because contracts are not fully drafted that novel circumstances can lead to difficult choices inviting the spirited legal discussions that keep the intellectual juices flowing.

Editor's Note: Shortly before publication of this issue of the *Journal*, the Delaware Supreme court issued its opinion in the appeal of *Broz v.*

Cellular Information Systems, Inc.,[30] one of the cases discussed by Professor Epstein in the preceding article. Chief Justice Veasey, writing for the three justice panel, reversed the chancery court's conclusion that Broz had usurped a corporate opportunity belonging to CIS. Approaching the case within the traditional contours of the corporate opportunity doctrine as articulated in *Guth v. Loft, Inc.*,[31] the court concluded that (1) a director's fiduciary obligations do not necessarily require that all opportunities be presented to the board for its approval, and (2) the fiduciary duties of a director of a target company do not require presentment of an opportunity to the target company's board when a potential acquiror has both the interest and ability to take advantage of the opportunity.

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[30]The full text is scheduled for publication in the Atlantic Second Reporter and is currently available on-line at No. 208, 1995, 1996 Del. LEXIS 105 (Del. Mar. 22, 1996).

[31]5 A.2d 503, 509 (Del. 1939).