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ARTICLE

Blinded by 'Fairness': Why We Need (Strong) Procedural Safeguards in Screening Self-Dealing and Obtaining a Fair Price Is Not the Answer

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Abstract
Ex post court review of related party transactions (RPTs) is one of the main mechanisms to deal with the problem of value diversion in public companies via self-dealing and is extensively made use of in Delaware and until relatively recently in most continental European countries. Such court review has also become to be known as the 'fairness test' whose contours may change depending on the jurisdiction and contexts in which it is applied. This study takes issue with the court review of *actualized* transactions under certain standards from two different perspectives. Firstly, it is argued that the behavioral insights derived from studies by behavioral economists and psychologists suggest that a legal regime that *solely* depends on the court review of *substantive merits* of RPTs without any (strong) procedural safeguard may fail to create a robust regime against value diversion. Secondly, acknowledging that the court review of substantive merits of RPTs may be inevitable in some cases, the study then turns its attention to the fairness test itself that compares the terms of an RPT to an arm's length transaction, and argues that such an objective test fails to fully prevent value diversion. Accordingly, a recalibration of the test and a new framework are proposed.

Keywords Related party transactions · Court review · Fairness test · Behavioral economics · Law and economics

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1 Introduction

Self-dealing transactions are an important issue to address in publicly traded corporations[1] in order to protect (minority) shareholders as public investors. They are a particular manifestation of the agency problem between controlling shareholders and minority shareholders in controlled companies and between directors/managers and dispersed shareholders in widely held companies. Through such transactions [also called related party transactions (RPTs)] corporate insiders (controlling shareholders and directors/managers)[2] may expropriate company value at the expense of (minority) shareholders. Jurisdictions resort to *ex ante* and *ex post* mechanisms to deal with the problem of value diversion in public corporations via self-dealing. *Ex ante* mechanisms manifest themselves in the form of procedural safeguards. By requiring *prospective* transactions with insiders to go through certain mechanisms, they attempt to create arm's length conditions (with an eye to obtaining a fair transaction for the corporation). *Ex post* mechanisms, on the other hand, include court review of *actualized* transactions under certain standards to prevent value diversion. Generally, courts police whether the company in question has suffered any prejudice from the transaction, although the exact manifestation of the court review varies in different jurisdictions.[3] Such court review has also become to be known as the 'fairness test' whose contours may change depending on the jurisdiction and contexts in which it is applied.[4] A procedural and a substantive safeguard can also be combined.[5] In fact, every jurisdiction uses a mix of procedural and substantive safeguards. Yet, the weight of protection provided by these mechanisms varies.[6]

Adopting *ex post* court review without any procedural safeguard in screening RPTs is in fact implementing a liability rule on RPTs.[7] Any liability rule like an *ex post* court review under a fairness standard removes the hold-out problem and any costs associated with going through the procedural safeguard.[8] The efficacy of such a review by a court in vetting self-dealing is well covered in the literature.[9] This study, however, puts forward two further, unrecognized problems of the *ex post* court review of RPTs. The first is theoretical. Based on behavioral insights derived

[1] Throughout this article, by companies or corporations are meant publicly traded or listed companies. Although self-dealing may also be problematic in non-listed companies, it is not the matter of concern in this article. For issues that may arise in closely held companies, see Fleischer (2018).

[2] Insiders are entities that have controlling power over a corporation, such as controlling shareholders in controlled companies or directors/managers in non-controlled companies.

[3] Enriques (2015), p 23.

[4] For example, in most European jurisdictions, standards of review have become different and looser for transactions between members of a corporate group. See Enriques (2015), pp 23–24; Enriques et al. (2017b), pp 163–64.

[5] Enriques (2015), pp 24–25 (explaining three ways in which procedural (*ex ante*) safeguards interact with *ex post* standard-based court review).

[6] See also Hopt (2018), p 620 (stating that 'more modern regulation is procedural').

[7] On the distinction between 'liability rules' and 'property rules' and their application in the context of RPT regulation, see *infra* nn. 42–44 and accompanying text.

[8] See *infra* text accompanying nn. 42–47.

[9] See, e.g., Goshen (2003); Pomelli (2016); Velasco (2004), pp 838–40; Enriques (2015).

from social studies, I argue that a legal regime that *solely* depends on the court review of *substantive merits* of RPTs without any (strong) procedural safeguard may create unintended and unhealthy consequences with regard to deterring value diversion via self-dealing by corporate insiders.[10] In the cost-benefit analysis of designing an appropriate regime against value diversion via self-dealing, lawmakers should also consider these consequences. Summarily, I submit that there are also behavioral grounds that may support implementing a type of procedural safeguard in screening RPTs alongside more traditional grounds that cast doubt on the efficiency and effectiveness of court review of RPTs.

The second problem with the *ex post* court review of RPTs which this study reveals is practical and relates to the current application of the fairness test in most jurisdictions. The basic test utilized by the courts when reviewing RPTs involves scrutinizing whether the terms of the RPT reflect what could have been obtained in an arm's length bargain. However, this study argues that whether an objective market price has been obtained should not be the only inquiry as transacting at the market price does not necessarily prevent the enrichment of corporate insiders at the expense of (minority) shareholders. The risk is that the transaction may result in a complete waste or a loss of value for the company even if the transaction price is fair or at the level of the market price, and even if corporate insiders share this loss, there may be related gains for them that offset their share of loss. So, RPTs should be evaluated not only objectively but also from the position of the company. What is needed is a test that also takes into account, *inter alia*, the subjective value of the asset which is bought or sold by the corporation, rather than a test that only ensures that the transaction corresponds to the objective market price. Accordingly, a new framework is proposed. Moreover, I argue that the appropriate remedy to deter corporate insiders from entering into value-diverting RPTs is disgorgement of profits. If the only consequence of the court review of RPTs (either under the current test or under the proposed framework) is compensation of the harm suffered by the company, related parties may still reap substantial benefits from the conflicted transaction. In other words, in addition to loss-based remedies (ensuring a fair price), there should also be a remedy for disgorgement of profits.

Section 2 starts with an account of the *ex post* court review of RPTs under substantive standards in different regimes alongside an examination of the potential benefits and problems associated with such a mechanism. Subsequently, Section 3 makes a new case for the need for (strong) procedural safeguards to oversee RPTs, based on behavioral insights. Section 4, acknowledging the persisting need for a court review of merits of RPTs in some cases, makes suggestions to recalibrate the test as applied by the courts in order to fully prevent the enrichment of corporate insiders at the expense of (minority) shareholders.

[10] Brudney, too, advocates both following a procedural safeguard (thus obtaining the corporation's consent) and requiring fairness to validate self-dealing transactions, but for different reasons. He questions the soundness of a procedural safeguard replacing a requirement of fairness. In other words, he objects to the cleansing effect of such safeguards given the uncertain authenticity of the consent obtained through a procedural safeguard. See Brudney (2000), p 215.

2 The Court Review of Related Party Transactions

The court review of RPTs involves any *ex post* inspection by courts of RPTs under certain standards to ensure that they are not prejudicial to the interests of the company, including (minority) shareholders. Jurisdictions may resort to such a review without or with accompanying procedural safeguards. Below, I examine the use of the court review as a main mechanism to prevent value diversion in some jurisdictions.

It is fair to say that in the US, or rather in Delaware, *ex post* court review of RPTs constitutes a main method although, as will be seen, courts incorporate procedural aspects into their review and/or encourage companies and corporate insiders to use procedural safeguards.[11] In Delaware, the main standard used by the courts is called 'the entire fairness test'. Controlling shareholders[12] and directors/managers are fiduciaries under Delaware law and their transactions with the company will be subject to such a test.[13] The test involves two aspects: fair dealing and fair price.[14] Fair dealing starts with full disclosure of the conflict and material facts surrounding the transaction, and involves considerations of how the transaction was initiated, structured, negotiated and approved. On the other side, fair price indicates the consideration of the substantive merit of the transaction. Generally, the former requirement boils down to the fact that an RPT occurs by following steps that mimic arm's length bargaining[15] while the latter involves the determination of whether the terms of the

[11] See in this regard Allen and Kraakman (2016), pp 292–327. See also Strine (2005), pp 677–79; Hamermesh and Strine (2019), pp 879–82 (explaining Delaware law on freeze-out mergers); Gilson and Gordon (2003), pp 796–803 (same). According to the Model Business Corporation Act, the transaction being established to have been fair to the corporation is sufficient for it to be valid without any approval by the disinterested board or shareholders, see § 8.61(b)(3) (1988). See also § 144 of the Delaware General Corporation Law.

[12] Delaware courts classify 'controlling shareholders' into three categories: (i) those having more than 50% of the company's voting rights, (ii) those having *de facto* control despite having less than 50% of the voting rights, and (iii) those establishing a control group of otherwise unaffiliated shareholders (through a contract, voting trust or any other agreement), see Rosenberg and Lewis-Reisen (2017), p 3.

[13] Although in *Weinberger v. UOP, Inc.* (457 A.2d 701 (Del. 1983)) where the canonical formulation of the entire fairness test was made, the issue was a squeeze-out merger, Delaware courts have applied this test to other self-dealing transactions with controlling shareholders and directors, see Licht (2020), pp 5–6 and cases cited therein. Yet, Delaware law has not been always very clear, see in this regard Hill and McDonnell (2011); Lazarus and McCartney (2011); Carney and Shepherd (2009). See also Velasco (2018), pp 1056–59 (noting a decrease in the rigor with which Delaware courts apply the entire fairness test).

[14] See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) ('The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock … However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.').

[15] Delaware courts delineated some factors in considering fair dealing, see, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n. 7 (Del. 1983) (appointment of an independent negotiating committee of out-

RPT (most importantly the financial terms) are comparable to those that would have been obtained in contracting with a non-related party.[16]

Controlling shareholders and directors/managers bear the burden of proving 'entire fairness'.[17] This is where the role of procedural safeguards (once more) comes into play.[18] In the case of transactions with controlling shareholders, the burden of proof shifts to the plaintiffs if the RPT was approved by a well-functioning committee of independent directors or a well-informed majority of disinterested shareholders.[19] In the case of RPTs that do not involve controlling shareholders (like RPTs with directors/managers), such approval leads to a review under the business judgement rule instead of the entire fairness standard.[20] A relatively recent decision with regard to mergers with controlling shareholders extended the review under the business judgement rule

Footnote 15 (Continued)

side directors); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1173 (Del. 1995) (independence of bargaining parties); *Sealy Mattress Co. v. Sealy, Inc.*, 532 A.2d 1324, 1337 (Del. Ch. 1987) (unfair dealing resulting from leaving the negotiation in the hands of a non-independent board with no advice from an independent financial advisor); *Gesoff v. IIC Industries, Inc.*, 902 A.2d 1130, 1150–51 (Del. Ch. 2006) (considering a special committee's receiving legal and financial advice that was not independent as an indicator that the parties did not structure a process in a way that was entirely fair); *In re Emerging Commc'ns, Inc. S'holders Litig.*, C.A. No. 16415, 2004 WL 1305745, 96–97 (Del. Ch. 2004) (considering the withholding of financial projections from the committee and its advisors as one of the elements of unfair dealing); *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1245–46 (Del. 2012) (the determination of unfairness influenced by the narrow power of the special committee to evaluate the proposed transaction with the controlling shareholder rather than a wider power to look at alternatives); *Kahn v. Lynch Communications*, 638 A.2d 1110, 1119 (Del. 1994) (emphasizing the power of the independent special committee to say 'no' to a transaction with the controlling shareholder).

[16] See Rosenberg and Lewis-Reisen (2017), pp 4–5 (detailing factors that are considered by the Delaware courts with regard to fairness of transactions with controlling shareholders). See however Velasco (2018), p 1058 (stating that courts 'have begun to focus on the importance of the substantive component of price', overshadowing the fair dealing component); Licht (2020), p 9 (noting that 'despite the unitary appearance of entire fairness review and the presentation of both process and substantive merit as necessary elements, in critical situations, price fairness could dominate and prove dispositive.').

[17] Rosenberg and Lewis-Reisen (2017), p 6.

[18] It seems that procedural safeguards play a role both in the fair dealing component of the entire fairness test and in shifting the burden of proof or the relevant standard of review. Yet, it is unclear how these two roles interact. See Gilson and Gordon (2003), pp 801–03 (asking 'what happens if the transaction structure fails th[e] initial fair-dealing inquiry and therefore does not operate to shift the burden of proof? If a transaction has to exhibit both fair dealing and fair price to be entirely fair, then how can the fairness standard ever ultimately be satisfied if … the fair-dealing component is not met?', and discussing the *Kahn I* and *Kahn II* cases). See further Enriques et al. (2017b), p 155 (stating in the case of a transaction with a controlling shareholder that 'while [vesting the task of negotiating the transaction in a committee of substantively independent directors and giving them the necessary resources (like access to independent legal and financial advice) to accomplish their task] may be *de facto necessary* to pass the "entire fairness" test applied by Delaware courts, it may not be *sufficient*, as Delaware courts tend to look at a wider range of facts.') [citations omitted] [emphasis in original].

[19] *Kahn v. Lynch Communications*, 638 A.2d 1110, 1117 (Del. 1994).

[20] *Michelson v. Duncan*, 407 A.2d 211 (Del. 1979); *In re Wheelabrator Techs., Inc., S'holders Litig.*, 663 A.2d 1194 (Del. Ch. 1995). See also Enriques et al. (2017b), p 154; Strine (2005), p 678.

to such transactions on the condition of dual approval, i.e., approval by a special committee of independent directors and the majority of minority shareholders.[21]

Delaware law differs from the standards of review applied by the courts in other jurisdictions in that it merges procedural and substantive aspects into a single oversight of RPTs. In continental European countries,[22] while the role of procedural safeguards has been limited, the *ex post* review of *substantive* merits of RPTs by courts appears to play a considerable role.[23]

In Germany, for example, there has, until very recently, been no overall, united concept and regulation of RPTs.[24] Until the very recent implementation of the Shareholders' Rights Directive II, there was a limited setting where some procedural safeguards could apply.[25] Courts, on the other hand, have abundant opportunity to

[21] *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014). See also Rosenberg and Lewis-Reisen (2017), p 10 (stating that there has been no case where this framework has been extended to non-merger controlling shareholder transactions, and arguing that it is likely that Delaware courts will extend this framework to other controlling shareholder transactions should the opportunity arise). Cf. Fiegenbaum (2017), p 763 (arguing against the application of the *MFW* framework to all controlling shareholder transactions).

[22] The United Kingdom is not examined because a procedural mechanism, rather than *ex post* court review of RPTs, namely the vote of (minority) shareholders, is the main mechanism used for the oversight of RPTs for companies with *premium* listing. For a detailed examination of the UK regime governing RPTs, see Davies (2019), p 361. Implementing the Shareholders' Rights Directive II, the Financial Conduct Authority promulgated new RPT rules for companies with *standard* listing, requiring the approval of the disinterested board regarding material RPTs. These rules are located in Chapter 7.3 of the Disclosure Guidance and Transparency Rules (available at https://www.handbook.fca.org.uk/handbook/DTR.pdf (accessed on 1 March 2022)). See similarly Tröger (2015), p 177 (stating that most Member States in the EU control the consumption of private benefits of control through *ex post* liability under substantive (fiduciary) standards of loyalty while others, particularly the UK, rely on *ex ante* shareholder involvement).

[23] See generally Tröger (2015), pp 177–81; Conac et al. (2007). This situation is posed to change after the implementation of the Shareholders' Rights Directive II in the Member States. The Directive basically requires, *at minimum*, Member States to subject RPTs to either disinterested board approval or approval by the majority of disinterested shareholders (or both). See Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement [2017] OJ L 132, Art. 9c [hereinafter Shareholders' Rights Directive II].

[24] Fleischer (2014), p 2691.

[25] The situations where one can observe a kind of procedural safeguards are the following: (i) certain purchases of company assets by some related parties in the two years following the company's formation (see § 52 *Aktiengesetz*); (ii) credit transactions with the members of the management board and supervisory board (see §§ 89 and 115 *Aktiengesetz*); (iii) transactions in which a member of the management board is the counterparty (see § 112 *Aktiengesetz*); (iv) professional service transactions with a member of the supervisory board (see § 114 *Aktiengesetz*). With the implementation of the Shareholders' Rights

review RPTs in cases based on the duty of loyalty of corporate insiders,[26] group law provisions, the prohibition of concealed distributions[27] and a specific criminal law provision as regards breach of trust (*Untreue*).[28,29]

France, too, makes limited use of procedural safeguards.[30] Although there is a requirement of board of directors' approval and shareholder ratification, the real protection against value diversion afforded by these steps is very weak.[31] *Ex post* court review of RPTs, on the other hand, remains important, and mostly takes the form of criminal liability for the abuse of corporate assets (*abus de biens sociaux*) and civil liability for directors authorizing harmful self-dealing practices in which case courts scrutinize whether the transactions have damaged the company.[32]

Footnote 25 (Continued)

Directive II into German law, material RPTs will be subject to the approval of the disinterested supervisory board or a committee thereof. If the relevant RPT is not approved by (either of) these bodies, it can be submitted to the vote of disinterested shareholders. For new RPT rules, see § 111a-c *Aktiengesetz*.

[26] Like in Delaware law (but unlike English law), in German law, controlling shareholders owe a duty of loyalty to minority shareholders. Value diversion through unfair RPTs would violate such a duty, see Fleischer (2014), pp 2696–97. In addition, according to § 117 *Aktiengesetz*, any person, using his/her influence on the company to compel members of management or the supervisory board to act to the detriment of the company or its shareholders will be liable for any damages suffered as a result (para. 7 provides however an exception in the cases of group companies). Similarly, in the case of a shareholders' vote on an RPT, if a shareholder, by exercising the voting right, sought to obtain special benefits for him/herself, or for a third party to the detriment of the company or the other shareholders, adequate compensation must be provided to injured shareholders to prevent the resolution of the general meeting from being voided. See § 243 *Aktiengesetz*.

[27] Any distribution of corporate assets to shareholders (except for dividend payments) is prohibited, see § 57 *Aktiengesetz*. The concept of distribution also includes transactions that transfer value from the corporation to shareholders, see Drygala (2011), § 57, paras. 37–94. See also Conac et al. (2007), p 499. Directors that execute the hidden distributions are also personally liable as there arises a violation of directors' duties, see § 93(3)(1) *Aktiengesetz*.

[28] See § 266 *Strafgesetzbuch*, which punishes any person that abuses the power accorded to him/her to dispose of assets, or make binding agreements for another person, or violates his/her duty to safeguard the property interests of another person when there arise damages as a result. The provision also applies to the members of the management and supervisory board of a company who consume private benefits of control. See also Conac et al. (2007), p 520.

[29] See Enriques (2015), p 24. See also Tröger (2019) (detailing the institutional change with regard to large public German companies which rendered the existing rules to curb controllers' extraction of private benefits largely defunct).

[30] See Helleringer (2019), p 403 (stating that 'France has so far made little use of the "trusteeship strategy".') and pp 418–21 (mentioning the limited role of independent directors or third parties and auditors).

[31] Although in the case of board of directors' approval, the interested board member is excluded from the vote, in the case of a transaction with a significant shareholder, the entire board (which is controlled by this shareholder) will vote on the transaction. The (disinterested) shareholders' vote is, on the other hand, *ex post* and has no bearing on the validity of the transaction, see Helleringer (2019), pp 406–08. Having an 'interest' in the transaction is also ambiguous and may be interpreted such as to leave out some potentially harmful cases, see ibid., pp 422–23. The relevant process for RPTs did not change after the implementation of the Shareholders' Rights Directive II into French law, see IBA Securities Law Committee (2019), pp 101–06.

[32] Helleringer (2019), pp 412–14. French courts may also set aside RPTs that are both non-authorized (by the board of directors) and prejudicial to the company, see ibid., p 415.

Italy, however, made an important step in utilizing strong procedural safeguards in its regulation of RPTs,[33] having previously mostly relied on *ex post* court review of RPTs and being considered as a jurisdiction of high-volume value diversion.[34]

In all these jurisdictions (Germany, France and Italy), courts have applied different standards for transactions between the members of a corporate group.[35] In the case of intra-group transactions, courts not only scrutinize a particular RPT, but also make an evaluation of the overall relationship of the company in question with the group.[36] However, jurisdictions follow different paths in doing so. Germany, being the strictest in this regard, requires in the case of both contractual and de facto groups[37] that any loss stemming from acting in the interest of the group rather than in the particular interest of the company in question be compensated.[38] In Italy, more flexibly, the parent will not be liable for any damage stemming from an intra-group transaction if it has been offset, taking into consideration 'the overall results of the parent's management and coordination activity'.[39] In France, the *Rozenblum* doctrine provides the most flexibility. As long as the structure of the group is stable,

[33] See Regulations Containing Provisions Relating to Transactions with Related Parties (adopted by CONSOB through Resolution No. 17221 of 12 March 2010, as amended and supplemented from time to time, available at https://www.consob.it/web/consob-and-its-activities/laws-and-regulations). In the case of material transactions, a committee of disinterested independent directors has to be involved in the negotiations, receive adequate information, and may express its views. Ultimately, it has veto power over the transaction – the transaction cannot be completed without the favorable opinion of this committee. Moreover, the committee may obtain the advice of a financial expert of its own choice at the company's expense. Companies have the option to subject the transaction that has received negative advice from independent directors to a vote of disinterested shareholders. If a majority of disinterested shareholders approve the transaction, it can still be entered into. If the disinterested shareholders represented at the meeting together hold less than 10 percent of the shares of the company, even if they reject the transaction, the company may still enter into the RPT in question. There are some exemptions for transactions that fulfil certain criteria from the requirements mentioned above, as well as a different procedure for non-material transactions (defined according to quantitative thresholds), see Bianchi et al. (2014), pp 10–14. There have been recent changes adopted by CONSOB to comply with the Shareholders' Rights Directive II but they do not alter the main architecture of the RPT regime.

[34] On the Italian law before the relevant CONSOB regulations, see Conac et al. (2007), p 499 (referring to some (weak) procedural requirements) and pp 500 et seq. (referring to duties imposed upon corporate insiders).

[35] See, e.g., Hopt (2018), pp 624–25; Conac et al. (2007), pp 503–05; Tröger (2015). See further on German group law, Hommelhoff (2001).

[36] Hopt (2018), p 624.

[37] Basically, while *de facto* corporate groups indicate control by the parent via share-ownership, contractual groups, as the name implies, refer to control by the parent via a control contract concluded between it and the controlled corporation.

[38] See § 302 *Aktiengesetz* (for contractual groups) and § 311 *Aktiengesetz*. In the case of failure to provide the controlled company with timely compensation, the controlling company is liable for damages to the former (jointly and severally with its representatives), see § 317 *Aktiengesetz*. There is also the obligation of the management board of the controlled company to prepare and submit to audit a dependency report (*Abhängigkeitsbericht*), covering the transactions entered into with the controlling company and other group members as well as the performance and consideration of these transactions, disadvantages incurred, and any advantages obtained in return, see §§ 312–313 *Aktiengesetz*. However, only a limited assessment is conveyed to the shareholders, see § 312(3) *Aktiengesetz*; and §§ 313(5), 314(2) *Aktiengesetz* (with regard to the auditor's and the supervisory board's assessment).

[39] Art. 2497 Civil Code.

there is a coherent group policy and an overall equitable distribution of costs and revenues among group members, subsidiaries may sacrifice their own interests for the corporate group and the parent may divert value from one of its subsidiaries.[40]

2.1 Benefits of the Court Review of RPTs

The merit of a tool to screen RPTs lies in whether such a tool prevents value-decreasing RPTs while allowing value-increasing ones, and this should be done preferably in a (most) cost-effective way. *Ex post* court review might well be an effective and efficient method of overseeing RPTs, especially if the setting allows a stringent and easy enforcement of standards to which RPTs are subject.[41]

The primary benefit of preferring the *ex post* court review of an RPT over an *ex ante* procedural (approval) requirement is the same as that of adopting a liability rule instead of a property rule.[42] Based on a novel theory that classifies legal protections against value diversion via self-dealing into 'property rules' and 'liability rules', Goshen defines legal protection as a property rule if 'any contemplated transaction tainted with self-dealing cannot proceed without the minority owners' consent', while 'a liability rule allows transactions tainted with self-dealing to be imposed on an unwilling minority but ensures that the minority is adequately compensated in objective market-value terms.'[43] The *ex post* court review of RPTs qualifies as a liability rule because without any procedural safeguard, corporate insiders will not need the consent of disinterested parties to execute an RPT, but will be required to enter into 'fair' RPTs.[44]

The benefit of such a rule is that it will prevent the hold-out problem. The procedural safeguards that empower (minority) shareholders to approve or veto the relevant RPT directly or indirectly (through the requirement of disinterested shareholder approval or the requirement of minority shareholder-dependent director approval) may lead (minority) shareholders to use this power to hold out in an attempt to extract more consideration from the related party, and may ultimately prevent

[40] Enriques et al. (2017b), p 164.

[41] There are many proposals on how to improve the court review of self-dealing practices in public companies, see, e.g., Hill and McDonnell (2011) (proposing a modest strengthening of judicial review of interested transactions in Delaware); Kang (2016); Gilson and Schwartz (2013).

[42] See generally on 'property rules' and 'liability rules', Calabresi and Melamed (1972). An entitlement is protected by a property rule if its transfer only happens in a voluntary transaction in which the value is agreed upon by the seller. A liability rule exists if the transfer of entitlement occurs at an objectively determined value despite the initial holder's unwillingness to sell at that value, see ibid., p 1092. Calabresi and Melamed also explain why we need liability rules at all: 'Often the cost of establishing the value of an initial entitlement by negotiation is so great that even though a transfer of the entitlement would benefit all concerned, such a transfer will not occur. If a collective determination of the value were available instead, the beneficial transfer would quickly come about', ibid., p 1106.

[43] Goshen (2003), p 398.

[44] Ibid., p 408.

beneficial and fair transactions from being carried out.[45] The prevention of the hold-out problem, however, may not be as real as readily assumed. Firstly, the value the minority attaches to the asset may be the correct value of the asset for the corporation, which indicates that the transaction was in fact unfair. Secondly, because holding out may also harm the minority (as there is a danger that beneficial and fair transactions will not be entered into as a result), the threat to hold out may not be that credible.[46]

Another benefit of adopting *ex post* court review instead of *ex ante* requirements is that the costs associated with other mechanisms can be done away with. For example, requiring RPTs to be subject to the approval of the majority of disinterested shareholders brings with it various other costs for companies. Holding an extraordinary general meeting for every RPT or deferring the completion of transactions until the date of the ordinary meeting, and obtaining fairness opinions from independent financial advisors to be sent to shareholders, dealing with activist hedge funds that may misuse shareholder votes on RPTs are a few examples of such costs.

Jurisdictions further make court review of RPTs available in different ways, even though they primarily adopt procedural safeguards to screen RPTs.[47] The reason is that procedural safeguards are not *value-diversion-proof* and resorting to a court serves as a complementary means. For example, the oversight of RPTs by an independent board or committee may not be effective because, simply put, independent directors may be biased in the case of transactions with their fellow directors,[48] may not be sufficiently informed,[49] or may be beholden to the controlling shareholder

[45] To understand this in the context of overseeing RPTs, assume that material RPTs have to be approved by the majority of minority shareholders as a matter of law or corporate rules. Assume further that a corporation has an asset that it values at $3 million and the related party, willing to buy the asset, values it at $4 million. In such a case, if the transaction (sale of the asset) happens between these values, it benefits both sides. If some of the minority threaten to hold out on their vote on the transaction, the related party (in a Coasian way) can pay them off and complete the transaction if the total of the Coasian bribe for this hold-out and the agreed transaction price remains below the value the related party attaches to the asset. If not, the transaction will not occur and thus a beneficial transaction will be missed. For example, assume that the agreed transaction price (between the board and the related party) is $3,500,000, but some of the minority argue that the transaction should happen if the consideration is $5,000,000 (in addition to an attempt to hold out in order to extract greater benefits, this may reflect an honest mistake as to the value of the asset), and that the holding-out minority's shareholding is 40%. The transaction will not happen in such a case because if the related party paid those holding-out shareholders their *pro rata* shares of the demanded consideration (i.e., $1,500,000 * 40% = $600,000), the total cost of buying the asset for the related party would be $4,100,000 (= $3,500,000 + $600,000), which is higher than the value he/ she attaches to the asset. Carrying out *ex post* court review in this case instead of requiring disinterested shareholders' approval (a procedural safeguard) would enable the parties to execute a mutually beneficial transaction at a fair price. In other words, the parties would execute the RPT at a value of $3,500,000, which would in turn be found 'fair' by the court as it is already higher than the price the corporation would demand in the market in a transaction with a third party.

[46] Rock (2019), p 115.

[47] As will be explained below, in some circumstances, court review of RPTs is inevitable. See *infra* text accompanying nn. 130–133.

[48] See, e.g., Velasco (2004); Davis (2005); Page (2009); Cox and Munsinger (1985); Hill and McDonnell (2007).

[49] See, e.g., Pacces (2019), p 209 (noting the trade-off between information and independence).

who appointed them in the first place or has the ability to remove them.[50] Moreover, in the case of a shareholder vote on RPTs, it is at least doubtful whether shareholders will be able and willing to cast an informed and genuine vote against value-diverting RPTs and for value-increasing ones.[51]

2.2 Problems with the Court Review of RPTs

As well as benefits, there are some problems with courts reviewing RPTs. As the efficacy of such a mechanism to screen RPTs is well covered in the literature, only a summary of such problems will be provided here.

The first and foremost concern is the ability of courts to understand and evaluate business transactions, let alone the problem of enforcement[52] (i.e., how easily and how often the duties of shareholders and directors/managers will be enforced). RPTs are more often than not complex transactions and it is important to allow value-increasing RPTs while preventing value-decreasing ones. It is a sophisticated task which not every court will be capable of conducting.[53] Often, expert opinions (on the value of the subject of the transaction) will be utilized. However, their accuracy and reliability are questionable.[54]

[50] See, e.g., Bebchuk and Hamdani (2017); Ringe (2013); Gutiérrez and Sáez (2013).

[51] Institutional and retail shareholders may have weak incentives to cast an informed vote, see Black (1990b), pp 526–29 (providing the classic rendition of shareholder passivity); Rock (2018), pp 373–74 (explaining the inadequate incentives hypothesis for institutional investor passivity). For conflicts of interest affecting institutional shareholders, see Black (1990b), pp 595–608; Coffee (1991), pp 1321–22; Rock (1991), pp 469–72. For the phenomenon of empty voting by shareholders, see Hu and Black (2016). See also Pacces (2019), pp 201–05 (explaining potential harms and benefits of activist hedge funds in screening RPTs); Rock (2019), p 135 (arguing that while it rarely does much harm, majority of the minority approval of RPTs does not seem to do much good); Gözlügöl (2021) (providing an analysis of institutional shareholder voting on RPTs).

[52] Enforcement includes liability suits as well as nullification suits. The latter can target either the nullification of general meeting or board resolutions approving a (value-diverting) RPT or the self-dealing transaction directly, see in this regard Conac et al. (2007), pp 513–17.

[53] See Enriques et al. (2017b), p 161, n. 113 (comparing non-specialized criminal courts where standards are enforced, like in Germany and France, with specialized civil law or corporate law courts that hear breach of fiduciary duty cases like Delaware's). See also Pacces (2019), pp 195–99 (arguing that substantive review of RPTs by courts deters value-increasing RPTs); Licht (2020), pp 33–34 (stating that '[b]ecause of their fiduciary position, corporate insiders enjoy absolute informational superiority vis-à-vis the company, its shareholders, and the court', and that expert evidence and acquired skills can mitigate a judge's informational inferiority but cannot overcome it). For more optimistic views, see Gilson and Schwartz (2013), p 167 (stating that '[a]n effective court commonly can recover the facts relevant to answering [whether the terms of a self-dealing transaction sufficiently resemble the terms that would obtain from arm's-length bargaining in the same transaction type]. Contract terms and prices are verifiable, market prices for similar transactions may exist, and expert testimony is often useful. Hence, courts can effectively police self-dealing'); Rock (2019), p 133 (noting that 'specialized judges can, with experience, become tolerably good at valuation.').

[54] Goshen (2003), pp 403–04; Licht (2020), p 33. See also Bebchuk and Kahan (1989).

Even if courts are capable players, the frequency and stringency of enforcement will remain an important issue.[55] Simply put, while the US courts are stringent in their review of RPTs and US (procedural) laws facilitate suits against corporate insiders, other jurisdictions lag behind.[56]

Along with the usual problems associated with enforcing the duties of fiduciaries before the courts and subjecting RPTs to demanding standards, there might be other important enforcement problems which are, however, also less likely to occur.[57] For example, as court review of RPTs is an *ex post* mechanism (or remedy), it is possible that until a lawsuit against the insider who engaged in unfair transactions emerges, the insider will hide or spend most of the gains and/or his/her wealth,[58] rendering any meaningful remedy impossible or costly to achieve. Moreover, if even disclosure of conflict is not required at the time of the transaction (but only happens later when the relevant RPT is disclosed in the annual accounts), it is likely that harm to the corporation will never be rectified.

3 A Behavioral Case for the Need for Procedural Safeguards

In Section 2, the *ex post* court review of RPTs as a mechanism to prevent value diversion in public companies and its potential benefits and problems have been examined. In this section, the issue of devising a proper tool to screen value diversion will be studied from a much different perspective. By doing so, another case (a behavioral one) for the need for procedural safeguards as regards the oversight of RPTs will be made.

3.1 The Behavioral Foundations of Corporate Law

Conventional analysis in the (corporate) law and economics literature in general and regarding the regulation of RPTs in particular centers on constraining opportunistic behavior through the use of legal and market incentives, namely external constraints,

[55] Enriques et al. (2017b), pp 164–65. See further Clark (1986), p 184 (considering the low probability of the occurrence of judicial scrutiny of self-dealing as one of its flaws, and finding it 'terribly expensive'); Goshen (2003), p 419 (stating that court review of RPTs will 'generate considerable adjudication costs.').

[56] Enriques et al. (2017b), pp 164–65; Enriques (2002), pp 794–801 (examining how Milan corporate law judges decide on self-interested transactions/resolutions); Tröger (2015), pp 177–81 (examining the legal framework in European countries that grants (minority) shareholders the right to bring suit and allows the same to identify tainted related party transactions); Conac et al. (2007), pp 507–12 (detailing the rules in Germany, France and Italy with regard to liability suits against corporate insiders, and noting that these remain rare) and pp 513–18 (detailing the rules in Germany, France and Italy with regard to nullification suits, and noting that while they appear quite common, the possibility of such suits rests on the existence of a shareholder vote on RPTs). See also Gelter (2012).

[57] See also Clark (1986), p 184 (stating that 'judicial scrutiny of fairness is a process that may be corrupted or diverted in various ways', and giving the example of lawyers settling the case instead of proceeding with full litigation which would better serve the interests of the shareholders).

[58] For this reason, Black advocates criminal liability for insiders who intentionally violate the self-dealing rules along with civil liability, see Black (2001), p 811.

based on the classic assumptions about human behavior. On the other hand, behavioral insights which challenge those classic assumptions, and analyses based on those insights have considerably found their way into scholarship with regard to many different issues[59] as behavioral law and economics have gained traction as a field.[60]

To start with, in their seminal article, Blair and Stout put forward the behavioral foundations of corporate law based on their analysis of social phenomena like trust.[61] Indicating that in contemporary legal scholarship 'the primary factors thought to discourage corporate participants from stealing, shirking their duties, or otherwise mistreating each other are market incentives and legal rules', they posit that 'corporate participants cooperate with each other not just because of external constraints, but because of internal ones.'[62] They also find the *homo economicus* model 'potentially misleading when it is applied to explain the relationship between corporate law and cooperative behaviour within firms.'[63] They largely draw on the experimental evidence of behavior in social dilemma games,[64] applying the insights developed in social studies to some corporate law puzzles and issues.[65]

Social dilemma is a phrase used by social scientists to refer to situations resembling the prisoner's dilemma game where cooperating is the worst strategy for the individual but the best for the group as a whole.[66] Among others, it has been observed in these experiments that people may act markedly different than expected from a *homo economicus*, displaying cooperative behavior and maximizing group welfare rather than maximizing their own individual welfare.[67] Social context has been shown to be a critical factor that affects whether participants in social dilemma

[59] For recent reviews, see, e.g., Winter (2018) (touching upon rulemaking, board performance and executive remuneration); Langevoort (2012); Zamir and Teichman (2018), pp 355–89; Greenfield (2014).

[60] The seminal work in this regard is Jolls et al. (1998). See also Korobkin and Ulen (2000).

[61] Blair and Stout (2001).

[62] Ibid., pp 1737–38. Particularly, they argue that 'the behavioral phenomena of internalized *trust* and *trustworthiness* play important roles in discouraging opportunistic behavior among corporate participants', see ibid., p 1738 [emphasis in original], and pp 1739–40 (describing trust 'as a willingness to make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one's vulnerability' and trustworthiness 'as an unwillingness to exploit a trusting person's vulnerability even when external rewards favor doing so').

[63] Ibid., p 1752, and p 1758 (criticizing the legal scholarship that assumes 'the best –indeed, only– way of controlling opportunistic behaviour is through legal and market incentives that discourage the shirking and stealing that is to be expected of rationally selfish individuals.'). See further Winter (2018), p 168 (finding the agency theory of rational self-interested wealth maximization incomplete without insights from behavioral studies); Greenfield (2014), p 518 (stating that 'it is safe to say that the global financial crisis of 2007–8 finally marked the end of the glory days of homo economicus.').

[64] Blair and Stout (2001), pp 1741 and 1759–80.

[65] Ibid., pp 1743 and 1780–89 (considering the nature and function of fiduciary duties), pp 1789–99 (considering the relationship between the duty of care and the business judgement rule) and pp 1799–1807 (discussing the case of closely held companies).

[66] Ibid., pp 1741 and 1759–60.

[67] Ibid., pp 1761–62; Stout (2003), pp 10–13. See also Sally (1995).

games pursue a cooperative (maximizing group welfare) or competitive (maximizing their own welfare) strategy.[68]

Along with Blair and Stout's pioneering work, one can now find numerous applications of behavioral insights to corporations and corporate law.[69] It also appears that another promising field of application is the regulation of 'self-dealing'. Self-dealing is problematic because the agency theory suggests that agents (directors/managers or controlling shareholders) will maximize their own welfare (to the detriment of the company and other shareholders) unless legal and market constraints are in place. However, it is now known that people are not that selfish.[70] In this regard, from the perspective of regulating RPTs, what is important is not only to put in place rules that prevent value diversion by self-regarding agents, but also to promote other-regarding behavior of these agents.[71]

3.2 Self-Dealing: A Cooperative or Competitive Game?

Self-dealing also roughly resembles social dilemmas in social scientists' parlance or the prisoner's dilemma in game theorists' jargon. It is a game played between corporate insiders on the one side and (minority) shareholders[72] on the other side. While cooperation between these groups, that is corporate insiders enter into only value-increasing RPTs or otherwise do no divert value, is the best for this group as a whole, it is in the interest of corporate insiders to divert value from the company, expropriating other shareholders. Legal and market incentives work towards preventing corporate insiders from diverting corporate wealth through external constraints,

[68] Blair and Stout (2001), pp 1768–73 (exploring 'instructions from authority', 'perceptions of group membership', and 'expectations regarding others' trust behavior' as important social variables that influence behavior); Stout (2003), pp 13–16. See also ibid., pp 21–22 ('social dilemma experiments suggest that almost anyone can be induced to cooperate altruistically, *if* the social context is structured to strongly support altruism …') [emphasis in original].

[69] For example, there is a substantial literature on the psychology-based analysis (including biases) of the boardroom of corporations, see, e.g., Langevoort (2004); Langevoort (2001) and sources cited in *supra* n. 48. For analyses on other corporate governance issues, see, e.g., Hoeppner and Kirchner (2016) (discussing the impact of insights of behavioral economics on governance strategies (monitoring and incentive contracting) to control agency problems); Morck (2008) (examining the separation of CEO and chairman of the board); Cain et al. (2005) (examining the psychological effects of disclosing conflicts of interest); Paredes (2005) (considering the implications of behavioral corporate finance and of CEO overconfidence for corporate governance); Langevoort, (2006) (examining corporate cultures); Arlen et al. (2002) (examining endowment effects within corporate contexts); Stout (2002) (examining socially contingent altruism and the business judgement rule); Greenfield and Kostant (2003).

[70] Winter (2018), pp 164–66. 'Bounded self-interest' which indicates that people may act to the benefit (sometimes detriment) of other people at the expense of their material self-interest is one of the main pillars of behavioral law and economics, see Jolls et al. (1998), p 1479.

[71] See also Winter (2018), p 168 (arguing that agency theory of rational self-interested wealth maximization should not be 'the sole theoretical basis for perceiving governance problems and designing regulatory or non-regulatory solutions to those perceived problems.').

[72] Of course, self-dealing may also harm creditors if the diversion of company value leads to default. But this article focuses on the conflict between (minority) shareholders and corporate insiders such as directors/managers and controlling shareholders.

thus making them cooperate rather than act in their sole interest.[73] While legal safeguards punish or at least undo value diversion, market mechanisms incentivize good corporate governance by punishing undesirable behavior in public companies.[74] In such games, however, it is also now known that behavioral insights matter. It is important to construct social contexts that create internal constraints as well.[75]

While scholars endlessly debate the shortcomings and merits of various legal safeguards to prevent value diversion in public companies through self-dealing, one of the aims of this study is to highlight one unaddressed advantage of relying on *ex ante* procedural safeguards rather than on direct *ex post* court review of RPTs based on the behavioral insights offered to us by social scientists and incorporated by some scholars into their analysis of corporate law, first and foremost by Blair and Stout. The end goal is to make the 'self-dealing game' *cooperative* (i.e., to make it work in the best interest of the company and thus all the shareholders) rather than *competitive*. As stated above, legal and market mechanisms serve towards this goal. However, I argue that utilizing procedural safeguards comes with the added advantage of framing a setting for cooperative behavior while sole *ex post* court review of the merits of RPTs would damage such a setting. In other words, procedural safeguards have the potential to promote cooperative behavior internally (as well as externally).

3.3 How Procedural Safeguards May Promote Cooperative Behavior in the Self-Dealing Game

Jurisdictions employ procedural safeguards to constrain the welfare-reducing, opportunistic behavior of corporate insiders when they attempt to turn the 'self-dealing game' into a competitive one (namely, when they attempt to divert value). Procedural safeguards may also directly impact the incentives of corporate insiders to divert value in the first place. For example, if a committee of independent directors were successful in vetoing value-diverting transactions, in the equilibrium, it would be expected that corporate insiders would not enter into such transactions in the first place. Instead of (or along with) procedural safeguards, jurisdictions also make use of substantive court review of RPTs, which again serves towards the attainment of the abovementioned goals.[76] As dramatic a departure as it may seem from the standard economic analysis, changing the internal preferences of corporate

[73] Some authors also point to 'social norms' that may affect the behaviour of corporate actors, see, e.g., Eisenberg (1999), p 1255 (defining 'social norms' as 'all rules and regularities concerning human conduct, other than legal rules and organizational rules'); Rock (1997) (excluding legal constraints, institutional structures, and market pressures); Cooter (1998); Coffee (2001). See also Tyler (2005), p 18 (arguing that people use 'social value judgements as a filter through which to shape their actions [in conflict of interest situations].').

[74] An examination of the market constraints on self-dealing can be found in Goshen (2003), pp 421–25.

[75] See also Winter (2018), pp 166–67 (explaining that 'social context matters').

[76] However, it should be noted that there are not sufficient incentives to encourage corporate insiders not to enter value-decreasing RPTs if the only consequence of doing so is a ruling of damages by the court that only compensates the harm suffered by the company, but does not provide for disgorgement of profits. In such a case, corporate insiders will continue to enter into value-decreasing RPTs only to compensate the harm suffered in the end if they can reap substantial benefits from the transaction.

insiders and encouraging the emergence of a cooperative stance by manipulating the social context may also be possible.[77] If one acknowledges this,[78] another advantage of employing a procedural safeguard and not resorting to court review as the only (or main) option for the oversight of RPTs emerges.

It has been stated above that social context plays an important role in framing a game as a cooperative one even though the rational strategy is to maximize one's own welfare (in other words, economic payoffs dictate not cooperating). For example, in social dilemma experiments, it has been identified that participants cooperate more instead of defecting when they were told to cooperate by an authority.[79] Normally, such a factor should not have a bearing on the rational decision to cooperate or not, which should only depend on a calculation of economic payoffs. In our context, too, self-dealing law utilizes this insight in a number of ways. Of course, law encourages cooperation primarily by affecting economic payoffs in undoing or preventing any value diversion. However, corporate insiders are also told that they are fiduciaries and need to act in the best interest of company; in other words, *to cooperate*.[80]

Blair and Stout state that 'the key to a successful fiduciary relationship lies in framing both economic *and* social conditions so as to encourage the fiduciary to make a psychological commitment to further her beneficiary's welfare rather than her own.'[81] In this vein, law encourages cooperative behavior by removing the expected gains from behaving to the detriment of the company (and its shareholders), but also 'by socially framing fiduciary relationships as relationships in which the law expects the fiduciary to internalize a commitment to pursue her beneficiary's interests rather than her own.'[82] So, legal rules of fiduciary law must promote

[77] See also Stout (2003), p 13 (referring to 'harnessing the phenomenon of other-regarding behaviour' by 'understand[ing] the factors and variables that are likely to promote other-regarding behaviour in the boardroom.').

[78] Although drawing on the social dilemma games that offer us important behavioral insights is important, a limitation in our context is that such games were set up to test 'two-way' trust in which case each participant both trusts and is trusted. In our self-dealing game, however, there is 'one-way' trust. While outside investors are the trusting party, corporate insiders are the trusted party. See also, in this regard, Blair and Stout (2001), p 1779. Cf. Winter (2018), pp 181–82 (noting that much of the behavioral literature does not directly relate to corporate settings, but arguing that 'the evidence is more than sufficient to merit at least paying careful attention to it in corporate law and corporate governance.'). See further Langevoort (2012), p 444 (noting that while it cannot be assumed that cognitive and behavioral biases observed in the general population exist in business settings, their presence cannot be ruled out either).

[79] Blair and Stout (2001), p 1770.

[80] See Stout (2003), p 15 (stating that 'directors might be inclined to behave in an other-regarding fashion simply because a respected authority asks them to do so.'). See also Blair and Stout (2001), pp 1780–89 (noting that 'fiduciary relationships are created by the law in situations in which it is efficient or otherwise desirable to promote other-regarding, trusting and trustworthy behavior.').

[81] Blair and Stout (2001), p 1785 [emphasis in original].

[82] Ibid., pp 1787. Blair and Stout also make a similar argument when they attempt to explain the divergence between the standard of conduct and the standard of review in breach of duty of care cases before the Delaware courts. Although Delaware courts apply the business judgement rule in most, if not all, cases and the risk of liability for directors is very low, they continue to exhort directors to exercise due care. The reason for this, they argue, is that '[c]orporate case law … can encourage corporate partici-

cooperative behavior both by threatening to sanction fiduciaries and by framing a setting in which they are prodded to cooperate. As regards self-dealing law, which can be deemed as an important part of fiduciary law, both *ex ante* procedural safeguards and *ex post* court oversight perform the first function (eliminating economic payoffs of not cooperating) although their effectiveness in this regard is greatly debated. I argue, however, that they differ in the second function, that is, framing a better social context where corporate insiders may make a better commitment to the well-being of the company.

By requiring corporate insiders to go through a tedious process that involves disinterested or independent players before concluding a transaction with the corporation, the law encourages corporate insiders to be cooperative not only by giving the disinterested or independent players veto power over the transactions they deem value-diverting, but also by framing the 'self-dealing game' as a process where other parties are involved and discuss the merits of the transaction. The context signals a call for cooperation to corporate insiders, which may indeed trigger this. By articulating such a process, law may influence the behavior of corporate insiders by changing their *internal preferences* (as well as their external incentives).[83]

A contrast may illuminate the idea better. Consider the situation that arises when RPTs are only subject to an *ex post* court review whereby it is determined whether the RPT in question is prejudicial to the company or not. First of all, corporate insiders have the ability to impose an *involuntary* transaction upon the corporation.[84] In other words, corporate insiders are at large to deal with the corporation without any input from the independent/disinterested bodies or from shareholders vulnerable to value diversion. To be sure, any business decision, such as entering into a transaction, needs to go through the relevant applicable procedure; however, as this procedure will be dominated by the insiders (without any procedural safeguard), whether the transaction happens or not is totally controlled by the insiders. Courts, in return, scrutinize the transaction under certain substantive standards, demanding mostly fair terms or value. In such a setting, corporate insiders freely enter into RPTs which may or may not be brought before the courts and which may or may not be found to be value diverting. This means that in some cases corporate insiders have the possibility to get away with value diversion (depending on the enforcement of the fiduciary duties and how capable the courts are of catching value diversion), and

Footnote 82 (Continued)

pants to internalize norms of cooperation through social framing–providing information about the social context of relationships within the firm.' In other words, courts preach fiduciary duty sermons 'primarily to influence corporate participants' behavior more directly by fleshing out the social context of their relationships, and particularly by framing relationships between managers and their firms as fiduciary relationships based on trust', see ibid., pp 1796–97. See similarly Allen (1998), p 329 (in relation to the dichotomy between the standard of conduct for corporate directors and the standard of judicial review in duty of care cases, referring to the 'difference between *the law as a utilitarian system of sanctions* designed to deter unwanted conduct and *the law as an expression of community ideals* designed to inspire solidarity around certain values') [emphasis in original].

[83] Blair and Stout (2001), pp 1744.

[84] See Goshen (2003), p 410 (stating that '[t]he fairness rule establishes a regime of involuntary transactions, and, thus, replaces subjective valuations of the contending groups of shareholders with an objective measure.').

in other cases they will mostly be required to either compensate the company for any harm or the transaction will be nullified. No matter how good the courts are at detecting value diversion and sanctioning it, which determines the payoff of the self-dealing game and thus external incentives,[85] such a setting does not stimulate an internal behavioral preference for corporate insiders to act in the best interest of the corporation. Rather, by leaving corporate insiders at large to deal with the company and other vulnerable shareholders playing tag to make corporate insiders account for their behavior, such a context both assumes and legitimates the adoption of a purely self-interested preference function by corporate insiders.[86] '[A] sphere in which the fiduciary can derive benefits from her office and redeem them – post hoc, if and when the company brings suit – at a decent price'[87] is clearly not conducive to promoting other-regarding/cooperative behavior by corporate insiders.[88]

The self-regarding function which the *ex post* court review of RPTs spurs corporate insiders to adopt becomes stronger if one considers another behavioral insight: the tendency to discount hyperbolically.[89] In other words, basically, people tend to reward the imminent benefits while discounting the non-imminent punishment.[90] In the *ex post* court review of RPTs, corporate insiders are to account for the harm suffered by the company after they have enjoyed the benefits for a while. In such a case, it is reasonable to believe that they will not be much concerned (irrationally) with the consequences of their breach due to a hyperbolic discount while they enjoy immediate private benefits. In that case, it is hard to promote cooperative behavior.

Attempting to resolve the difficult issue of screening RPTs through sole *ex post* court review instead of adopting strong procedural safeguards may also have another negative effect with regard to changing corporate insiders' internalized preferences and framing

[85] See however Stout (2003), p 6 (arguing that the remedy for a breach of the duty of loyalty, namely undoing value diversion, does not have much of a deterrence effect on corporate directors). See also *supra* n. 76.

[86] Blair and Stout (2001), p 1784. See also Stout (2003), p 15 (making a similar argument with regard to the stock compensation for directors which is claimed to reinforce selfish motivations and undermine altruistic ones). Without regard to the behavioral stimuli that arise from the social context created by the legal safeguards against value-diverting self-dealing, some authors also contend that a liability-rule-like regime (that is, a regime which only relies on *ex post* vetting of RPTs by the courts) does not fit the fiduciary duty (and the basic tenets of fiduciary law) and may ultimately harm the trust underlying such a duty. See generally Mitchell (1993); Licht (2019), p 461 (arguing that '[a] fiduciary does not take; a fiduciary asks. The property-rule/liability-rule framework … underscores this facet of the issue – that of unilateral taking by the fiduciary. Allowing fiduciaries to engage in RPTs in a liability-rule-like regime is tantamount to giving them a licence to expropriate with impunity.'); Licht (2020), p 4 (stating that 'review by the court of a tainted fiduciary action in order to verify its substantive fairness, and consequently to validate it, is foreign – indeed, inimical – to fiduciary loyalty and accountability as these legal institutions are understood throughout the common law world, Delaware included.').

[87] Licht (2020), p 15.

[88] In contrast to the conventional view, Licht even argues that breach of duty of loyalty cases are more lenient and accommodating to corporate fiduciaries than cases of breach of duty of care where courts generally refer to the business judgement rule, see ibid., p 16. Furthermore, he argues that for non-corporate fiduciaries the law is truly more onerous and exacting, see ibid., pp 17–19.

[89] See Jolls et al. (1998), pp 1539–41 (explaining hyperbolic discounting and its implications).

[90] Ibid., p 1539 (stating that 'impatience is very strong for near rewards (and aversion very strong for near punishments) but that each of these declines over time …').

a social context where corporate insiders are encouraged to conceive their relationships with the company and other shareholders as cooperative ones. An important finding of the experiments of behavior in social dilemma games is that the decision to cooperate or not also depends on the participants' perceptions of others' expectations and likely behaviors.[91] Translating this finding into the corporate law context, Blair and Stout argue that while fiduciary lawsuits may deter opportunism by creating a threat that such behavior will be punished, at the same time, they 'unavoidably send the signal that others in the business world are choosing to violate their fiduciary duties. The more suits brought, the stronger the signal.'[92] A similar effect can be observed as regards self-dealing. The higher the number of cases that concern value diversion from the company by corporate insiders and thus breach of fiduciary duty, the more likely that such behavior will be signaled as normal and common to corporate insiders. The advantage of employing a strong procedural safeguard instead of or along with an *ex post* court review is that some value diversion may be prevented within the company. Fewer cases before the courts may positively shape expectations about what other players are likely to do (players not in the sense of counterparties playing the same game but all the participants playing the same self-dealing game), which in turn may affect the decision to cooperate or not (in other words, to divert value or not).[93]

Therefore, the existence of procedural safeguards, rather than adopting mere *ex post* court review of RPTs (i.e., a liability rule regime), may harness the social context necessary to impede the self-regarding function of corporate insiders. Admittedly, not every procedural safeguard will function to the same extent in this regard. The potential effect of the procedural safeguard in this context will be a function of its ability to create a real arm's length bargaining environment.[94]

Furthermore, some authors emphasize the role of law in expressing and reinforcing social norms, which may in turn affect the behavior of subjects of social norms.[95] Eisenberg

[91] Blair and Stout (2001), p 1796.

[92] Ibid., p 1797.

[93] This idea can be traced back to the concept of social influence, the phenomenon that 'individuals tend to conform their conduct to that of other individuals', see Kahan (1997), pp 352–61 (explaining and discussing the concept of social influence, and giving the example of 'the signalling effect of criminal behavior'). A similar concept is called 'reputational externalities', which 'concerns the extent to which events in some firms affect expectations in others', see Shleifer and Summers (1988), pp 45–46. Although there still might be several cases of value diversion before the courts even after the adoption of (strong) procedural safeguards (see also *infra* text accompanying nn.130–133), even a small reduction (or increase) in the number of cases may affect how corporate insiders perceive the context which shapes their relationships with the company based on the phenomenon of 'tipping point'. The same phenomenon may be observed when social norms shift, see Eisenberg (1999), p 1264 (citing Schelling (1978), pp 91–102).

[94] See, e.g., Enriques et al. (2017b), p 153 (explaining different shapes in which the involvement of boards in the approval of related party transactions can come); Winter (2018), p 175 (stating that the involvement of non-executive directors may vary from ratifying, probing, engaging to directing). See also *infra* text between nn. 111–112.

[95] See *supra* n. 73, as well as Sunstein (1996) (exploring 'the expressive function of law – the function of law in "making statements" as opposed to controlling behaviour directly', and particularly 'how legal "statements" might be designed to change social norms'). See further Tyler (2005), p 33 (advocating for a regulatory strategy that emphasizes the activation of social values which is argued to moderate the influence of self-interest).

and Rock argue in different articles that corporate fiduciary law drives the behavior of corporate agents (care and loyalty) not through the threat of liability but by influencing the development of social norms.[96] They further contend that people might obey social norms because they may internalize these norms[97] or because of the consequences attached to a failure to obey.[98] In this sense, self-dealing law may also express and reinforce the already existing social norm of *not stealing*. Corporate insiders may be driven by the fear of (social) sanctions they foresee if they are caught diverting value from the company. However, this relates more or less to external constraints on the behavior of corporate insiders that determine the incentives to engage in a certain behavior (i.e., a reflection of *homo economicus*). More importantly and in line with the theme of this study, corporate insiders may rather internalize the norm of *non-value diversion*.[99] Relatedly, creating a setting by law that facilitates the preference of cooperative behavior internally may also reinforce social norms in this regard and lead corporate insiders to internalize them.[100]

In brief, the self-dealing game is in essence a competitive one. That is, rationally, corporate insiders would endeavor to maximize their own welfare through value diversion to the detriment of the company itself and its shareholders.[101] Legal and market mechanisms are in place to avert this. Yet, it is unreasonable and unfair to perceive all corporate insiders as 'thieves'.[102] Some are trustworthy without any legal or market sanction for any contrary behavior.[103] Social studies also reveal that

[96] See Eisenberg (1999), p 1265; Rock (1997), p 1016.

[97] See Eisenberg (1999), pp 1258–61; Rock (1997), p 1013.

[98] Rock, for example, refers to 'public shaming' ('disdain in the eyes of one's acquaintances, the loss of directorships, the harm to one's reputation'), see Rock (1997), p 1104. Cf. Blair and Stout (2001), pp 1795–96 (downplaying the role of social sanctions in the case of controlling opportunism in corporations). See similarly Eisenberg (1999), p 1261 (stating that '[w]ithout a significant degree of internalization … reputational effects will usually be insufficient.').

[99] See also Coffee (2001), p 2176 (expressing that 'to the extent that … behavioral forces independent of the market and legal sanctions are seen as shaping cooperation within the firm, then the private benefits of control are likely to be determined by the strength of the normative consensus within the broader society within which the corporation functions.').

[100] See similarly Blair and Stout (2001), pp 1796–97. See also Eisenberg (1999), pp 1273–74 (among the ways to achieve loyalty by corporate actors, considering the operation of the social norm of loyalty as the least expensive and the most effective, and arguing that 'whatever the law does do to increase the force of the social norm of loyalty, and further its internalization, will lead to greater efficiency and will therefore benefit shareholders as a class.').

[101] See, e.g., Kang (2015) (explaining in which ways controlling shareholders would rationally endeavor to maximize their own utility).

[102] See, e.g., Goshen and Hamdani (2016) (doubting the view that most corporate controllers are opportunists who take advantage of minority shareholders).

[103] See similarly Dammann (2019), p 242 (drawing on the experimental literature on trust in economic relationships, and stating that 'in a corporate setting, controlling shareholders may, in some situations, honor the trust placed in them by minority shareholders even in the absence of compelling legal or economic incentives to do so.'). Generally, the behavior consistent with external legal and market incentives leads one to deem the latter as the cause of the former while this behavior would have happened without such incentives, see Blair and Stout (2001), pp 1741 and 1758. This has been shown by the social dilemma experiments where the incidence of cooperation was far higher than could possibly be explained by external incentives alone, see ibid., p 1762. However, the same experiments also show that people have different tendencies to cooperate or not and are affected by past experiences, see ibid., pp

such cooperative behavior can be cultivated internally and the law does this in a number of ways. In this regard, I submit that implementing a (strong) procedural safeguard in the oversight of RPTs would be a right step in this direction. One may doubt the value of constructing a setting which promotes cooperative behavior internally in the face of extensive legal and market mechanisms in today's capital markets. Yet, each mechanism has its own limitations and costs, which makes it important that corporate insiders are nudged into changing their preferences.[104] Granted, economic stakes in non-cooperation may be great, which would lead corporate insiders not to cooperate (that is, to divert value).[105] This is the reason why virtually all legal regimes and markets implement measures against value diversion via self-dealing.[106] However, one should also consider in the cost-benefit analysis of such measures how they affect the internal preferences of corporate insiders based on behavioral insights alongside external incentives.[107]

3.4 Evaluation of the Current Legal Regimes

At this point, an evaluation of the current legal regimes based on the previous parts should be made. In light of these explanations, the 'fair dealing' prong of the Delaware courts' entire fairness test becomes sounder. Delaware courts not only scrutinize the substantive merits of a transaction but also pose a series of other

Footnote 103 (Continued)

1764–66 and 1766–68. Another setting where cooperative or trust behavior, rather than legal or market forces, plays an important role seems to be closely held corporations, see ibid., pp 1799–1807.

[104] See ibid., p 1755 (stating that 'no combination of legal rules and market forces can bring agency costs in firms down to zero.'). See also Moore and Loewenstein (2004), pp 199–200, who argue that 'the violations of professionalism induced by conflicts of interest often occur automatically and without conscious awareness' and 'cultivating [the] mindset [of ethical behaviour and compliance with rules] … is one key to blunting the potentially destructive power of conflicts of interest.'). The example of Arthur Andersen which the authors examine shows how the change of mindset may turn a company with an unimpeachable reputation to a company entangled in corporate scandals, see ibid., pp 189–190.

[105] See Blair and Stout (2001), pp 1773–75 (pointing to studies that found that 'while people do cooperate in social dilemma games, as the personal cost associated with cooperating rises (that is, as players' expected gains from defection increase), cooperation rates begin to decline.'); Stout (2003), pp 16–20 (same).

[106] Moreover, as long as external constraints reduce the payoffs from value diversion via self-dealing, it is more likely that corporate insiders will demonstrate cooperative behavior even if they can still divert some value since cooperation increases as the personal cost of cooperation decreases, see sources cited in *supra* n. 105.

[107] Besides, small gains from promoting cooperative behavior through changing preferences (as well as payoffs) may add up to great gains at the margin, see Blair and Stout (2001), p 1775 (noting that 'even small acts of trust, when aggregated over many players and many transactions, can add up to very big gains.'). See also Langevoort (2012), p 445 (arguing that '[i]f the regulatory intervention would fail because it ignores th[e] [behavioural] effect even in a relatively small number of instances, the aggregate cost – the legal risk – might still be material. Simply assuming rationality because that is the best available description of behavior ignores the ecological diversity of outcomes in judgment and decision-making in social and economic settings, and hence the risk embedded in the broad societal "portfolio" of choices.').

requirements that create an arm's length dealing environment.[108] Scholars have questioned this approach, asking '[t]o what else are shareholders entitled beyond a fair price?'[109] In addition, one might think that in terms of external incentives for corporate insiders to divert value, the fair terms component is sufficient because it removes any payoff from self-dealing, deterring insiders from diverting value via self-dealing in the first place.[110] Yet, there also exists the requirement of fair dealing which corroborates the idea that self-dealing law is also concerned with the behavioral message it conveys. This approach is consistent with the setting corporate law should create as regards the oversight of self-dealing, as argued above. Furthermore, conventionally, the 'fair dealing' aspect of the entire fairness test has been understood as creating arm's length bargaining with the ultimate aim of obtaining fair terms. In other words, the fair dealing aspect has been subordinated to the fair terms aspect. However, 'fair dealing' is important on its own as far as behavioral stimulus is concerned, whether it leads to a fair price for the company or not.

From this standpoint, it is also regrettable that in some cases before Delaware courts, one can observe a de-emphasizing of fair dealing and rather a focus on fair price aspect.[111] On the other hand, Delaware courts also encourage the use of *ex ante* procedural safeguards by making it harder for the plaintiffs to challenge a self-dealing transaction approved by independent directors or disinterested shareholders.[112]

Procedural safeguards, however, may not be adequate on their own. For example, the requirement of disinterested board approval in the case of a transaction with the controlling shareholder may not be really meaningful for minority shareholders as the entire board, which is dependent on the controlling shareholder, will vote on the transaction.[113] Nevertheless, even this requirement conveys the message that the controlling shareholder cannot freely and easily enter into transactions with the controlled company without the approval of the board of directors who are supposed to represent the company and owe fiduciary duties to (minority) shareholders. However, this does not mean that all procedural safeguards would be the same in terms of the setting in which they put corporate insiders when dealing with the company. For instance, a special committee of independent directors which has the power to negotiate, to obtain information (as well as obtain advice from a financial expert of its

[108] See *supra* text accompanying nn. 11–21. See also *In re Nine Sys. Corp. S'holders Litig.*, C.A. No. 3940-VCN, 2014 WL 4383127, *46–47 (Del. Ch. 2014) (concluding that a conflicted transaction, even if it was conducted at a fair price, was not an entirely fair transaction because of the grossly inadequate process employed by the Defendants). However, Goshen characterizes Delaware law as a liability rule regime, see Goshen (2003), p 426. As long as the 'fair dealing' component of the entire fairness test must be satisfied and it involves a sort of consent of the independent actors, then the characterization of Delaware law as a liability rule regime is not correct.

[109] Gilson and Gordon (2003), p 798, n. 41.

[110] However, unless the remedy is disgorgement of profits, corporate insiders may still reap benefits from unfair RPTs even if they compensate the company for the harm suffered. See also *supra* nn. 76 and 85.

[111] See in this regard Velasco (2018), pp 1058–59; Licht (2020), pp 9–10.

[112] See *supra* text accompanying nn. 17–21. See also Goshen (2003), p 429 (stating that '[Delaware] courts prefer a shift from a liability rule–which would require the courts' ruling over valuation issues–to a property rule–in which case the courts' role is to judge the appropriateness of the voting procedure.'); Licht (2020), pp 25–32 (noting the transformative process of Delaware's law in this regard).

[113] Such is the case in France, see *supra* n. 31.

own choice at the company's expense) and to veto the transaction strongly implies that corporate insiders do not have a free hand and will not be left to be chased to account for the transaction (in the sense of playing tag); rather, they need to follow a cooperative procedure. The US (Delaware), Italy and Belgium implement such a setting in different degrees.[114] There are also proposals to give 'minority shareholders-dependent directors' screening power over RPTs.[115] If adopted, not only may they strengthen the effectiveness of board approval as a procedural safeguard in preventing value diversion via RPTs,[116] but they will also contribute towards developing a social context where corporate insiders may internalize a preference for cooperative behavior.

In this regard, the Shareholders' Rights Directive II is a welcome development in the EU.[117] Although the procedural safeguards have been greatly watered down in

[114] For example, in the case of transactions with controlling shareholders, for the approval of RPTs by a special committee of independent directors to be given effect under Delaware law, it must fulfil some requirements: the independent special committee must (i) be charged with the task of obtaining the best available deal, not only with the task of negotiating a fair deal, (ii) have the power to say 'no', and (iii) be vested with resources to accomplish its task, see Allen and Kraakman (2016), p 327. In Italy, independent directors have veto power over RPTs, full access to information and assistance from financial and legal experts of their own choice at the company's expense, see *supra* n. 33. Furthermore, in Italy, a minimum of one seat on the board of directors is reserved for a person that will be nominated and elected by minority shareholders, see Enriques et al. (2017a), p 80. See also Pomelli (2016), pp 79–80 (discussing the differences in the mandates/tasks of independent directors when reviewing RPTs between Italy and Delaware). In Belgium, intra-group transactions are subject to a special procedure (see *Code des Sociétés*, Art. 524): such transactions are referred to a committee of three independent directors which will carry out an assessment of the transaction in question. However, the board is not bound by the opinion of the independent directors. The committee may also be assisted by independent experts for technical advice at the company's expense. Furthermore, the statutory auditor is to give an assessment as regards the accuracy of the data in the committee's opinion, see Cordt and Colard (2010).

[115] See, e.g., Pacces (2019), pp 185 and 209–12 (introducing 'noncontrolling shareholder-dependent directors' to the board and giving them *only* the power to screen RPTs); Gutiérrez and Sáez (2013), pp 90–94; Ringe (2013), pp 421–24. The latter two articles do not restrict the function of minority shareholders-dependent directors to only screening RPTs.

[116] They are not free from criticism, however. See, e.g., Pacces (2019), pp 212–16 (sharing the potential criticisms of his own proposal).

[117] See *supra* n. 23 for full citation.

the legislative process,[118] the end product requires Member States to adopt at least a procedural safeguard,[119] the strength of which depends on the Member States' implementation of the Directive.[120]

Finally, US (Delaware) law may, at first glance, appear a bit different because procedural requirements/safeguards are incorporated into *ex post* court review. However, the ultimate outcome is the same. If corporate insiders fail to follow procedural requirements/safeguards, they will fail the entire fairness test or be subject to a more challenging inquiry. In other jurisdictions, if they ignore procedural requirements, they will face whatever consequences are attached to such conduct (nullification, compensation, fines, punishment, etc.). Delaware law may even be deemed a step ahead because, thanks to its comparatively strict and easy enforcement, corporate insiders may be less willing to disregard procedural requirements.

3.5 Conclusion

Although corporate law and governance have been a bastion of the traditional law and economics approach (based on the rational actor model), behavioral considerations regarding the corporate actors have become ubiquitous in studies. While the law might not yet have found the sweet spot with regard to the regulation of RPTs,[121] it may be beneficial to also utilize the behavioral insights offered to us by social sciences in preventing value diversion through self-dealing.[122] In this vein, this study

[118] The Proposal by the European Commission subjected material RPTs to the approval of a majority of minority shareholders and required a fairness opinion by an independent third party to accompany the real-time announcement of the RPT, see European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, Art. 9c, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2014%3A213%3AFIN. The final Directive, after the amendments in the legislative process, relaxed these requirements and increased the scope of RPTs exempted from the requirements, see Gözlügöl (2020).

[119] See Shareholders' Rights Directive II, Art. 9c/(4). However, the Directive leaves substantial room for discretion in determining the sanctions attached to ignoring the procedural safeguards. It only requires effective, proportionate and dissuasive penalties for Member States to implement in the case of infringements of national provisions adopted pursuant to this Directive. This does not categorically rule out a regime according to which RPTs need to be only 'fair' even if they did not pass through the relevant procedures, rather than being directly invalidated. See also Tröger (2015), p 189 (arguing that such a regime does not provide for the effective, proportionate and dissuasive penalties EU law calls for).

[120] Member States may devise a procedural safeguard that relies on disinterested or independent members of the board, disinterested shareholders, or a combination of both. Member States may also make use of independent third party assessments in the process. See for the measures taken by the Member States to implement the Directive, https://eur-lex.europa.eu/legal-content/EN/NIM/?uri=CELEX:32017L0828 (accessed on 1 March 2022).

[121] See, e.g., Pacces (2019), p 184 (arguing that the UK and Delaware regimes that are deemed to be the most effective in preventing value diversion can still be improved at the margin).

[122] See in this regard Blair and Stout (2001), p 1808 (stating that '[m]istaken assumptions about the role and importance of external incentives in furthering cooperative behaviour can lead not only to mistaken descriptions but also to mistaken prescriptions.'); Winter (2018), p 169 (stating that 'when corporate law and governance mechanisms are then evaluated or promoted solely on the basis of models applying full

indicates the benefits of *ex ante* strong procedural safeguards in contrast to mere *ex post* review of substantive merits of RPTs by courts in consideration of creating a social context that promotes cooperative behavior by corporate insiders.

In addition to informing sound RPT regulation, behavioral insights may also demonstrate in what (type of) companies cooperative behavior is most or least likely to emerge, allowing shareholders themselves to focus on problematic companies and to intervene if necessary.[123]

Generally, corporations and business settings have been thought to be immune from deviations from the rational actor model because 'irrational' actors would be eliminated from the market.[124] Although research also abundantly shows that 'irrationality' may survive in such contexts,[125] the above contention is true to a certain extent. However, in our setting of self-dealing, the supposedly irrational behavior (not diverting value from the company) is highly beneficial, and would promote the individual corporate insiders who do not divert value and the corporations which do not harbor self-dealing, rather than eliminating them from the market.[126] The existence of such 'irrational' behavior becomes more obvious when one thinks of a question asked by a group of scholars: 'If there are gaps in … laws, and some tunnelers do indeed take advantage of them, then why aren't tunneling opportunities more widely exploited?'[127]

Nevertheless, there is another important factor to consider: how likely it is for the behavioral insights observed in the social experiments to be duplicated in the self-dealing context.[128] Admittedly, there should be further empirical observation in this regard before more concrete steps can be taken.[129] There is great potential for research here with regard to the bounded self-interest of corporate agents and devising legal rules in channeling this towards well-known goals such as preventing value diversion.

Footnote 122 (Continued)

rationality and self-interest maximization as assumptions, the analysis becomes flawed. This runs the risk of corporate law and corporate governance regulation that precisely does not strengthen but weakens corporate decision making and responsibility.').

[123] See Lesmeister et al. (2018).

[124] See Langevoort (2012), p 443; Greenfield (2014), p 524.

[125] See Langevoort (2012), p 444; Greenfield (2014), pp 524–28.

[126] See also Blair and Stout (2001), pp 1753–59 (arguing that corporations that promote trust among their stakeholders 'can reduce and, in some cases, avoid many of the costs associated with policing against opportunism', providing them with an advantage over the firms that bear such costs).

[127] Atanasov et al. (2011), p 36. See also Black (1990a), p 573 (stating that 'culture [and] the developed sense of proper and improper behavior plays an important role in managers' self-restraint.'). Tunnelling is another term used to indicate value-diverting self-dealing practices by corporate insiders, see Johnson et al. (2000), p 22 (defining 'tunnelling' as 'transfer of assets and profits out of firms for the benefit of those who control them').

[128] See also Blair and Stout (2011), pp 1777–80 (noting 'the potential pitfalls of relying on such experiments to predict human behaviour in the far more complex environment of the corporation.').

[129] See Stout (2003), p 24 (suggesting 'field testing' before more broad changes in corporate law based on the results of experimental studies); Langevoort (2012), p 445 (emphasizing 'the need for corporate legal scholars to build their normative arguments on a solid base of empirical observation – preferably in the field – rather than simply borrowing from laboratory research in psychology generally.').

4 Recalibrating the Fairness Test

The need for procedural safeguards, based either on the behavioral case made above or on other grounds, generally does not remove the need for court review of RPTs and thus for the fairness test. This may be so because, as mentioned above, procedural safeguards are not entirely able to prevent value diversion from the company.[130] Moreover, it should be acknowledged that an *ex post* court review of an RPT's merits is inevitable in some cases even though there exists a proper procedural safeguard to prevent value diversion. Such cases include the following. Firstly, when the relevant procedural safeguards are not followed and the transaction cannot be unwound due to complexity, the court needs to award rescissory damages, which will necessarily include an evaluation of the terms of the RPT.[131] For example, after a parent-subsidiary merger that did not follow the relevant procedural requirements, it may be impossible to break up the merged company (i.e., to unscramble the eggs). Secondly, even if the transaction can be rescinded, the asset sold by the company might have been acquired by a bona fide third party.[132] This means that the transaction not duly approved, though void *inter se*, is not void toward a third party who did not know or should not have known about the lack of approval. Thirdly, in the case of approval by (a committee of) independent directors, the courts might need to review the terms of the RPT when ruling on the duty of care and the good faith of the approving directors.[133] Lastly, procedural safeguards may not apply to all RPTs. For example, the requirement of disinterested shareholder approval may only apply to material transactions defined quantitatively or qualitatively. In this case, for other transactions, a claim can still be made before the courts under a fiduciary duty standard.

As much as we may need to rely on *ex post* court review of RPTs in the context of RPT oversight, I argue that there is a need to recalibrate the test applied by the courts when reviewing transactions in order to ensure that value diversion from the company does not occur. The proposal is, in the most simple terms, that there should be a shift from primarily considering the objective value of the asset to considering its subjective value in some cases.

[130] See *supra* text accompanying nn. 47–51.

[131] Rock (2019), pp 133–34. See also *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) ('Since it is apparent that this long completed transaction is too involved to undo, and in view of the Chancellor's discretion, the award, if any, should be in the form of monetary damages based upon entire fairness standards, i.e., fair dealing and fair price.'). Cf. Licht (2020), pp 40–42 (stating that '[t]his concern, albeit not unfounded, is nonetheless overstated', and differentiating between 'substantive fairness review' as 'validating breach' and 'remedy').

[132] See Enriques (2000), p 300.

[133] See Rosenberg and Lewis-Reisen (2017), p 9 (examining two Delaware cases where these issues came up); Eisenberg (1993), p 455 (contending that 'th[e] good faith requirement allows a judicial inquiry into fairness, since the courts can hold that a transaction that is clearly unfair cannot be approved in good faith [by disinterested directors]'). Furthermore, in cases where the business judgement rules applies, as in the case of approval by disinterested shareholders or independent directors of transactions with directors/managers in Delaware law (see *supra* n. 20), the 'waste' standard will be applicable, which can be thought as 'particularly egregious or extreme forms of unfairness', meaning that there might be a review by the court of the merits of an RPT, see Yablon (1991), p 502.

4.1 The Current Test

In the most basic understanding, the court, in its *ex post* review of an RPT, applies the arm's length criterion, namely comparing the transaction in question with a market transaction concluded at arm's length.[134]

In reality, however, the task is more complicated. When the object of an RPT is a homogenous asset/service, there will be a market price and then necessarily the relevant benchmark will be this market price because the company could easily perform an alternative transaction in the market at the market price.[135] If there is no market price, however, or the object of an RPT is a differentiated asset/service, the court has to consider the range of prices at which a reasonable buyer or seller would be willing to buy or sell the asset/service, mostly depending on the objective valuations of experts.[136]

In each case, however, the basis of the evaluation of the deal is objective valuation, whether from a market price perspective or a reasonable buyer/seller perspective.[137] Nevertheless, I submit that objective valuation will not necessarily prevent value diversion and ensure that corporate insiders do not extract private benefits

[134] See Rock (2019), p 133 ('the arms' length price … provides an important benchmark: the terms offered the firm cannot be worse than the closest available arms' length transaction.'); Pacces (2019), p 183 ('A substantive review evaluates the RPT in comparison with a market transaction concluded at arm's length.'); Goshen (2003), p 403 ('Under the fairness test, the court evaluates the terms of the transaction in comparison to market parameters.'). See however Clark (1986), p 173 (noting that '[t]he problem cannot be solved by resort to the usual arm's length bargain or competitive market tests of fairness' in some cases, for example, the parent-subsidiary agreements about tax savings).

[135] In such a case, one can also reasonably question the entering into the RPT in the first place. See, e.g., Eisenberg (1988), p 997 (stating that 'in perfect markets involving only homogeneous goods, there would usually be no reason for a corporation to transact with a director or senior executive rather than transacting on the market.').

[136] See Eisenberg (1988), p 999; Yablon (1991), pp 504–07. See also Revised Model Bus. Corp. Act § 8.60 (2016) (official comment), pp 228–29 (stating that '[g]enerally a "fair" price is any price within a range that an unrelated party might have been willing to pay or willing to accept, as the case may be, for the relevant property, asset, service or commitment, following a normal arm's-length business negotiation.'). Delaware courts also follow this approach, see, e.g., *In re Dole Food Co., S'holder Litig.*, C.A. No. 8703-VCL, 2015 WL 5052214, 73 (Del. Ch. 2015) ('For purposes of determining fairness, as opposed to crafting a remedy, the court's task is not to pick a single number, but to determine whether the transaction price falls within a range of fairness.'); *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 466 (Del. Ch. 2011) ('When conducting a fair price inquiry as part of the entire fairness standard of review, the court asks whether the transaction was one that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept' (citing *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1143 (Del. Ch. 1994))).

[137] The only subjective element comes from the subjective assessment by experts and courts of the objective value, see Goshen (2003), p 420. Some scholars also argue that Delaware courts have used higher standards than the fairness test as currently understood, see Licht (2020), pp 35–39 (referring to the availability of a 'fairer price' in some cases of breach of fiduciary duty); Yablon (1991), p 512 (arguing that terms such as 'full fairness', 'entire fairness', 'intrinsic fairness', or 'the most scrupulous inherent fairness' used in case law set a higher standard than mere fairness).

from the transaction to the detriment of (minority) shareholders, as explained in detail in the next part.[138]

4.2 A Proposal

The risk with the current test lies in the fact that objective valuation will not always be a good proxy for the value of the asset for the company[139] and for the value diverted from the company. One should rather consider the counterfactual, comparing the situation after the transaction with the situation of the company if the transaction had not happened.

Sometimes, the absurdity of comparing the terms of an RPT to a market transaction will be obvious. For example, 'if a manufacturing company that lacks sufficient working capital allocates some of its scarce funds to purchase at a market price a sailing yacht'[140] from a controlling shareholder, the fact that the price paid for the yacht was a market price will apparently make the transaction pass the relevant test. Obviously, the company can undo the transaction in the market (i.e., sell the yacht) and recover the working capital. However, it will incur transaction costs and be deprived of the working capital for a period of time. One can reasonably assume that the balance sheet of the company will seem different after and before the transaction.

In other cases, value diversion will be subtler. In such cases, despite the fact that the transaction will happen within the reasonable range of market prices, the value lost by the company will be higher than the consideration it obtains. This may be because the specific asset will generate more value for the company than its objective valuation. In other words, the subjective value of the asset is more than its objective value. For example, if a sale of distribution facilities by the company to a corporate insider will affect its competitiveness with a rival company in an area and thus result in less profitability, the company will still lose value as a result of the sale, even if the latter has occurred within a reasonable range of market prices. There might also be positive/negative synergies between the assets, and transferring some assets from or to the company might reduce the value of remaining assets for the company and thus its profitability.[141] In such cases, even the best price obtainable in the market may not reflect the true (subjective) value of the asset for the company.

In all these cases, although it seems that value is lost as a result of the RPT, at first glance, it is not in the interest of the controlling shareholders to make the company

[138] For another critique of the arm's length criterion, see Pacces (2019), p 196. See further Kang (2016), pp 132–136 (detailing the issues faced by the courts and regulatory agencies in relation to fair market price).

[139] Goshen (2003), p 403 (stating that 'the use of an objective measuring standard leaves no place for unique characteristics or special assessments of value that might affect the value the parties themselves actually ascribe to the assets') and p 410 (expressing that '[t]he fairness rule establishes a regime of involuntary transactions, and, thus, replaces subjective valuations … with an objective measure.').

[140] Revised Model Bus. Corp. Act § 8.60 (2016) (official comment), p 228.

[141] See Atanasov et al. (2014), pp 1700–01 and 1704–05; Atanasov et al. (2011), pp 5 and 8.

lose value because they will share the loss *pro rata* depending on the size of their shareholding and will not gain from the transaction as the latter happens within the reasonable range of market prices. So, one can reasonably assume that if the transaction appears to conform to market realities, then the RPT will not be against the interest of the company, nor of its shareholders.[142] Yet, this will not always be the case. Controlling shareholders may compensate their loss resulting from the company's suffering through profits generated via assets bought from the company or via utilizing the consideration from the sale of an asset to the company.[143] Back to the above example, if the controlling shareholder uses the distribution facility he/she bought from the company at a market price in order to make his/her other business more profitable, then he/she can easily offset losses resulting from the operations of the controlled company. A further example (but where the controlling shareholder is on the seller side of the transaction) may be a transaction whereby the controlling shareholder sells an asset to the company at the market price to meet his/her liquidity needs. Such a transaction means diversion of company funds from the company operations to fulfill the controlling shareholder's needs, which may translate into a value loss (in the sense of opportunity cost) for the company. Even if the company will lose value as a result and the controlling shareholder will share this loss *pro rata*, it can be in his/her interest to enter into this transaction if his/her loss would be bigger should he/she not sell the asset to the company to meet his/her liquidity needs. Such cases are summarized in the Table 1 below.

Moreover, such transactions may be entered into with directors/managers who do not have a (substantial) economic stake in the company nor need to worry about their positions even if the company loses some value as a result of the RPT.

Therefore, even if an RPT conforms to arm's length transactions, there still might be a value loss for the company.[144] If such a suspicious fact pattern is identified, an assumption should arise that controlling shareholders (who would normally lose from such transactions on a *pro rata* basis) derive private benefits from entering into these transactions, enough to offset their losses. In any event, if there had been no

[142] Pacces indicates that '[i]t might be tempting to subject the scrutiny of related-party transactions to a substantive standard. After all, what enables non-pro-rata distributions is the departure of self-dealing from market conditions. Therefore, it is often held by lawyers that related-party transactions are fair as long as they are carried out at arm's length', see Pacces (2011), p 194. However, as explained in the text, it is crucial to understand that complying with market conditions does not necessarily ensure non-value diversion.

[143] Controlling minority structures also make it easier to compensate any loss because the cash flow rights of the controlling shareholder will be much smaller than his/her control rights. For controlling minority structures and how they are formed, see Bebchuk et al. (2000).

[144] One can object that although the substantive value of an asset is higher for the corporation than its market price, and thus there is a potential loss, the corporation may reverse the transaction in the market at the market price (which was paid previously) and reinstate the subjective value. However, there are several counter-arguments against this: (i) it assumes a liquid and non-volatile market for a *homogenous* good, (ii) there would be further transaction costs involved with the second transaction and one may legitimately question why the company should bear this (unnecessary) cost, and (iii) there might be potential loss until the time the company is able to reverse the transaction on the market and reinstate the subjective value.

Table 1 Stylized summary of the abovementioned cases

(i) $T_{0:}$ Let X be the object of an RPT and P the market price for this object. X belongs to the company and creates a value worth 2P for the company. Assume further that there is a controlling shareholder, holding 50% of the shares.[a]

T_1: When X is sold to the controlling shareholder at the market price P, both the controlling shareholder and minority shareholders as a group lose each P/2 value as a result of this transaction because the company loses a value of 2P while only gaining a value of P. On the other hand, if the controlling shareholder is able to produce more than a value of P/2 from utilizing the asset, it will be in his/her interest to enter into such a transaction.

(ii) T_0: Let X be the object of an RPT and P the market price for this object. X belongs to the controlling shareholder who is holding 50% of the shares. Assume further that using company funds for its transfer to the company would cause a loss of P/2 in the value of the company.

T_1: When X is sold by the controlling shareholder to the company at the market price P, both the controlling shareholder and minority shareholders as a group lose each P/4 value as a result of this transaction because the transaction causes a loss of P/2 in the value of the company. On the other hand, if the controlling shareholder is able to produce more than a value of P/4 from the consideration he/she received from the sale of the asset, it will be in his/her interest to enter into such a transaction.

[a] Although holding 50% of the company shares will not ensure unchallengeable control, it will suffice in most, if not all, cases

surplus for the controlling shareholder from entering into such an RPT, the transaction would not have happened in the first place.

Based on these considerations, a new scheme for court review of RPTs is proposed. In the case of transactions with controlling shareholders, a court may still first look at whether the transaction conforms to the terms of an arm's length transaction, the controlling shareholder carrying the burden of proof . If the transaction seems to have been carried out on market terms, the court may reasonably assume that there is no value diversion from the company because it is not normally in the interest of controlling shareholders to enter into RPTs that harm the company but do not offer them gains over market prices. However, if the plaintiffs could demonstrate the loss in the value of the company as a result of the relevant transaction, the court, as a principle, should rule for damages as such a suspicious situation indicates that there might be other gains for the controlling shareholder. Then, the controlling shareholder should be allowed to prove that he/she entered into the transaction in good faith, meaning that he/she rationally believed that it was in the best interest of the company.[145]

A simpler framework should apply to directors/managers. Similarly, the first step will be to analyze the terms of the RPT in order to determine whether it conforms to market realities. The plaintiffs should be allowed to establish that even if the transaction conforms to market conditions, the company has lost value as a (direct) result of

[145] Demonstrating that there were no profit opportunities for the controlling shareholder after the transaction may be a way of proving 'good faith' in entering into the transaction.

the transaction. The court, then, should rule for damages unless the directors/managers are able to show that they entered into the transaction in good faith.[146]

Obviously, such a framework would be more difficult to implement.[147] Yet, at the same time, it would provide more protection against value diversion. Like the current court review of RPTs, it would work best in a regime with courts involving sophisticated judges adept at understanding and solving financial matters, and with procedural rules that allow the parties to acquire as much information as possible from the counter- and third parties. This is simply because such a framework would involve more complex financial valuations and projections,[148] and the plaintiffs would need more information (which may be in the possession of other parties) to back their claims. On the other hand, such a framework would provide a more efficient allocation of resources as it may prevent transfer of resources from the party that most values it (the company) to another party (corporate insiders).[149]

In addition, one may argue that such a framework may lead to undue involvement of the courts *ex post* in business decisions that are made *ex ante*, which is generally undesirable because of the difficulties/perils associated with such review.[150] Yet, this framework would only slightly (if at all) expand the courts' review of the business decision that led to the relevant RPT. In this framework, as a rule, the courts will still conduct their traditional analysis (i.e., comparing the terms of RPTs to their arm's length counterparts). However, they will not stop when they establish that the RPT in question was carried out on market terms. In case there is sufficient proof that the RPT was still harmful for the company even though it was on market terms, the court will directly rule for damages (without any inquiry into the merits of the business decision to enter into the RPT) because, as explained above, especially in the case of transactions with controlling shareholders, such a situation suspiciously indicates that there might still be value diversion from the company (i.e., private benefit extraction by the insider). When the related party uses the opportunity to

[146] Similarly, demonstrating that there were no private benefits for directors/managers that would offset any loss they would suffer derivatively from the company loss (as a result of stock compensation) may go some way towards showing 'good faith' in entering into the transaction.

[147] However, Delaware courts have already hinted at the departure from the 'fair price' inquiry in some cases, see *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 467 (Del. Ch. 2011) ('Depending on the facts and the nature of the loyalty breach', a 'fairer' price may be available); *ACP Master, Ltd. v. Sprint Corp.*, C.A. No. 8508-VCL, 2017 WL 3421142, 48 (Del. Ch. 2017) ('the range of fairness is not a safe-harbor that permits controllers to extract barely fair transactions. Factors such as coercion, the misuse of confidential information, secret conflicts, or fraud could lead a court to hold that a transaction that fell within the range of fairness was nevertheless unfair compared to what faithful fiduciaries could have achieved.'). See also Revised Model Bus. Corp. Act § 8.60 (2016) (official comment), p 228 ('In considering the "fairness" of the transaction, the court will be required to consider not only the market fairness of the terms of the deal—whether it is comparable to what might have been obtainable in an arm's length transaction—but also (as the board of directors would have been required to do) whether the transaction was one that was reasonably likely to yield favorable results (or reduce detrimental results).').

[148] See Goshen (2003), p 420 (stating that '[t]he use of objective standards simplifies the task of evaluations since it is easier to place an objective value on an asset than to determine a subjective value.').

[149] A liability-rule-like regime that imposes only a fair price requirement impairs efficient resource allocation, see Licht (2019), p 461, n. 37.

[150] See, for example, Armour et al. (2017), p 70 (explaining the law's deference to corporate decision-making).

establish that the transaction was entered into in good faith (to avoid a damages ruling), the court's review of the business decision to enter into the RPT is still minimal and limited to establishing whether the related party could sufficiently argue that he/she rationally believed that the transaction was in the company's best interest.[151]

One further point is that the remedy for an unfair transaction (as understood currently or in the new framework) should be disgorgement of profits.[152] Damages (either rescissory or other) or a remedy based on the appraisal standard will not be sufficient to deter corporate controllers from entering into value-decreasing transactions.[153] The reason is that even if they are held accountable to pay damages for unfair transactions, they will still be able to reap substantial benefits from the transaction, which may exceed the amount they need to pay to the company.[154]

In brief, the fact that the RPT in question conforms to market conditions that would have been obtained in an arm's length relationship does not mean that (i) the company does not lose value as a (direct) result of the transaction, and (ii) the controlling shareholder/directors do not gain any private benefit from the transaction. There might still be cases where there is value diversion in the broadest sense. A better framework is needed to take account of these situations as well as to provide proper remedies.

5 Conclusion

Almost all regimes implement measures against RPTs through which corporate insiders may enrich themselves at the expense of (minority) shareholders. In particular, two mechanisms come to the forefront: (i) *ex ante* procedural safeguards which leave the task of policing RPTs in the hands of disinterested parties before the transaction in question is completed, and (ii) *ex post* court review of the merits of completed RPTs. Obviously, each mechanism has its own merits and shortcomings, and

[151] In any case, the good faith requirement may also be present in the case of the business judgement rule that the courts generally apply to avoid any undue inquiry into the business decisions of corporate insiders, see ibid. (2017), pp 69–70.

[152] See also Licht (2019), p 461, n. 32, and p 474, n. 92 (arguing that '[t]he appropriate remedy against a breaching fiduciary is accounting in equity …'); Licht (2020), pp 38–39 (noting some cases before the Delaware courts that went further than awarding or contemplating rescissory damages).

[153] Disgorgement of profits is a sanction that restores the wrongdoer to the same position which he/she would have been in but for the wrongdoing. Given that the probability that a sanction will be imposed is less than 1, even if the sanction is disgorgement, 'an agent cannot be deterred from appropriating the principal's asset' absent some kind of punishment, see Cooter and Freedman (1991), pp 1048–56. Nevertheless, there might be some additional 'informal and incidental elements of punishment' for breaches of duty of loyalty, see ibid., pp 1071–74. See further Eisenberg (1999), p 1276 (arguing that 'if the only reason for not violating the duty of loyalty was the prospect of a legal sanction, fiduciaries would regularly violate that duty. The social norm of loyalty, however, adds the sanction of loss of reputation to the legal sanctions.').

[154] See also *supra* nn. 76 and 85. Of course, the proper remedy remains damages when the harm suffered by the company is greater than the gain of the corporate controller.

certainly, the particularities of each jurisdiction may dictate how to devise proper RPT regulation.[155]

This study approaches *ex post* court review of RPTs from a theoretical and practical perspective. First, it endeavors to demonstrate how sole reliance on *ex post* court review of RPTs without utilizing (strong) procedural safeguards may impair the robustness of a legal regime against value-diverting self-dealing. Departing from a traditional law and economics analysis that operates on the classical assumptions of human behavior, this study draws on behavioral insights distilled from social studies and indicates that the context created by a liability-rule RPT regime (i.e., a regime that relies only on *ex post* court review of RPTs) may not be conducive to harnessing non-opportunistic behavior of corporate controllers. Admittedly, this analysis remains tentative without relevant empirical observations in the field. Yet, scholars and regulators have long recognized the limits of conventional tools,[156] and new ways of making agents/fiduciaries respect the interests of principals/beneficiaries may prove valuable. It is also highlighted that self-dealing is a fertile ground for behavioral research, which so far has remained within the confines of conventional analyses.

Secondly, I argue that there is a need for a better test to be used by the courts when reviewing RPTs in order to fully prevent value diversion from companies. Although this study advocates making use of (strong) procedural safeguards based on the behavioral insights explained above, *ex post* court review of RPTs remains both necessary and inevitable. Nevertheless, the arm's length criterion constitutes the main test for the courts and lacks the sophistication needed to avert the less direct attempts of corporate insiders to divert value from the company. In this regard, this study proposes a new framework for the courts to adopt. Although it is more difficult to implement, it is necessary to prevent transactions that cause loss for the company but may benefit corporate insiders. Likewise, I submit that following a breach of the fiduciary duty, the proper remedy is disgorgement of benefits, not damages. Otherwise, the latter would allow corporate insiders to reap substantial benefits from entering into value-decreasing RPTs while only compensating the harm suffered by the company. This is important as far as the incentives to deter corporate insiders from entering into value-diverting RPTs are concerned.

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[155] See Gilson (2018).

[156] See the quotes cited in *supra* n. 122.

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