



Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers

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The background law

- ▶ The duty of loyalty is a foundational part of corporate law, and a crucial part of it is the corporate opportunities doctrine.
 - ▶ This is true in both India and the US
- ▶ In the US, the duty of loyalty has traditionally been the centerpiece of *mandatory* corporate law
- ▶ Motivations
 - ▶ Does market forces promote optimal corporate governance arrangements
 - ▶ Do companies even tailor around defaults?
- ▶ The duty of loyalty is of particular interest for two additional reasons:
 - ▶ Whose interests should corporate managers serve?
 - ▶ Should any of corporate law's rules be mandatory?
 - ▶ Do corporations make use of the power to opt out of defaults in charters?

DGCL § 122(17)

[As Amended, July 2000]

- ▶ Every corporation created under this chapter shall have power to

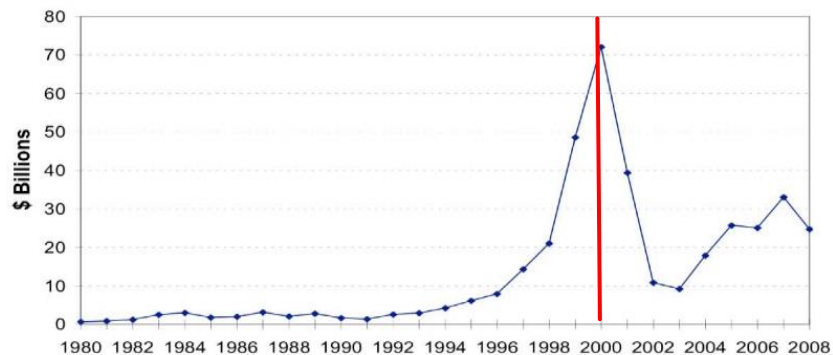
...

- ▶ (17) Renounce, **in its certificate of incorporation or by action of its board of directors**, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation **or 1 or more of its officers, directors or stockholders.**
- ▶ *Cf: § 102(b)(7) (Duty of Care; 1986)*
 - ▶ *Must be in charter; only for directors; only for \$ damages; numerous other limitations / strings attached*
- ▶ 8 other states have enacted statutes similar to § 122(17) in ensuing years

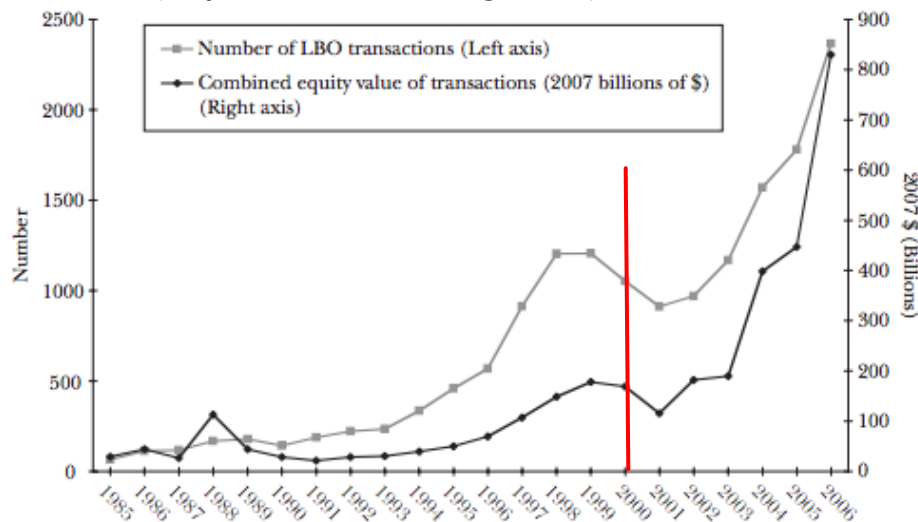
Why the reform?

Venture Capital & Private Equity

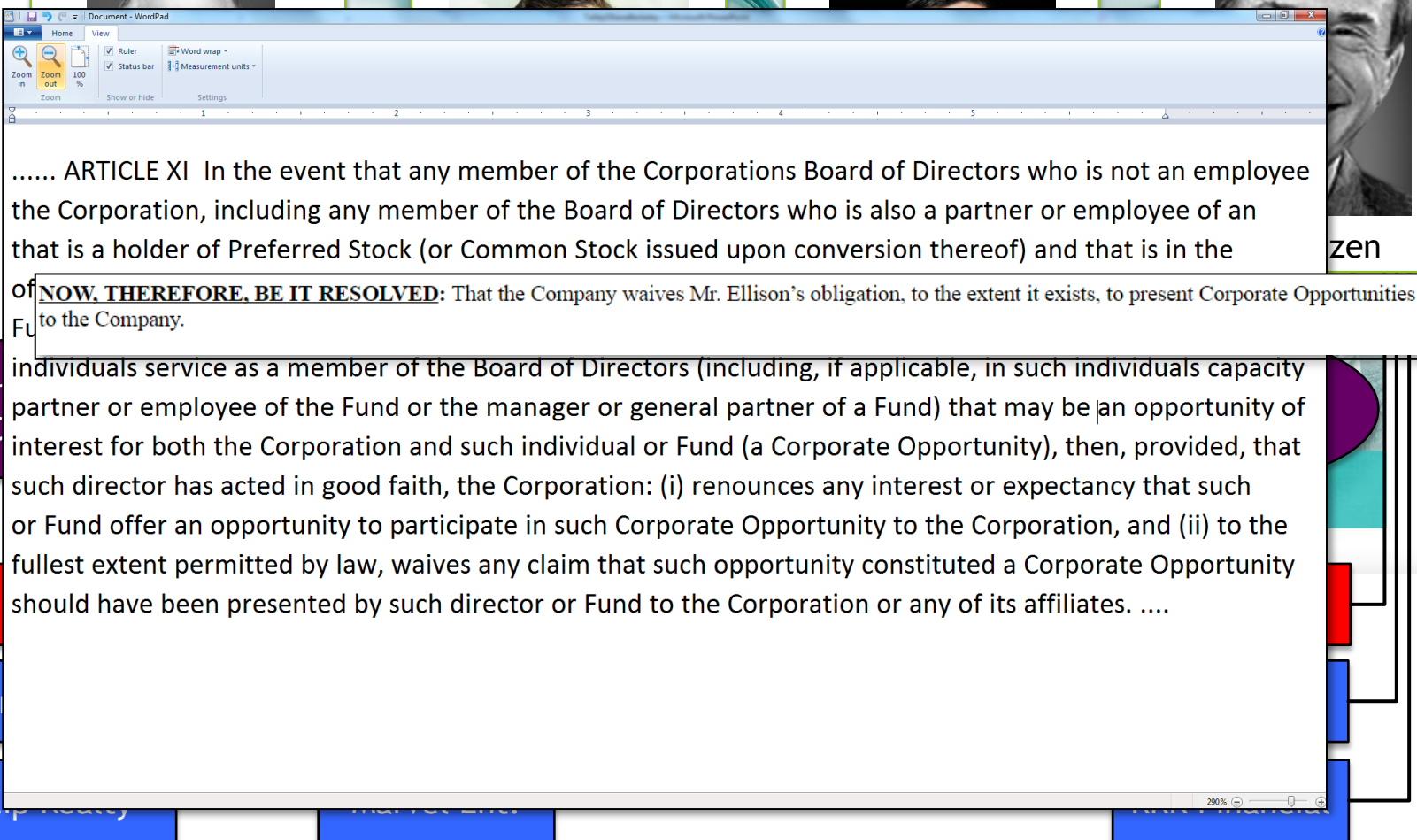
Commitments to Venture Capital Partnerships 1980-2008
(Kaplan & Lerner 2009)



Global Private Equity Transaction Volume 1985-2006
(Kaplan & Stromberg 2009)



Prosper Marketplace Outside Directors (2007; S-1)



..... ARTICLE XI In the event that any member of the Corporations Board of Directors who is not an employee of the Corporation, including any member of the Board of Directors who is also a partner or employee of an entity that is a holder of Preferred Stock (or Common Stock issued upon conversion thereof) and that is in the

of **NOW, THEREFORE, BE IT RESOLVED:** That the Company waives Mr. Ellison's obligation, to the extent it exists, to present Corporate Opportunities to the Company.

individuals service as a member of the Board of Directors (including, if applicable, in such individuals capacity as a partner or employee of the Fund or the manager or general partner of a Fund) that may be an opportunity of interest for both the Corporation and such individual or Fund (a Corporate Opportunity), then, provided, that such director has acted in good faith, the Corporation: (i) renounces any interest or expectancy that such director or Fund offer an opportunity to participate in such Corporate Opportunity to the Corporation, and (ii) to the fullest extent permitted by law, waives any claim that such opportunity constituted a Corporate Opportunity should have been presented by such director or Fund to the Corporation or any of its affiliates.

Project Addresses 3 Questions (1 conceptual and 2 empirical)

- ▶ Are there plausible reasons to believe that corporate opportunity waivers could make shareholders better off in a broad range of circumstances?

YES

- ▶ Have public companies made use of their newfound power to “contractualize” the duty of loyalty by renouncing/waiving corporate opportunities in advance?

YES

- ▶ Has the reform exacerbated bad behavior / agency costs in adopting companies, antithetical to shareholder interests?

NOTSOMUCH
(likely vice versa)

Why might it be in a firm's interest to waive the COD?

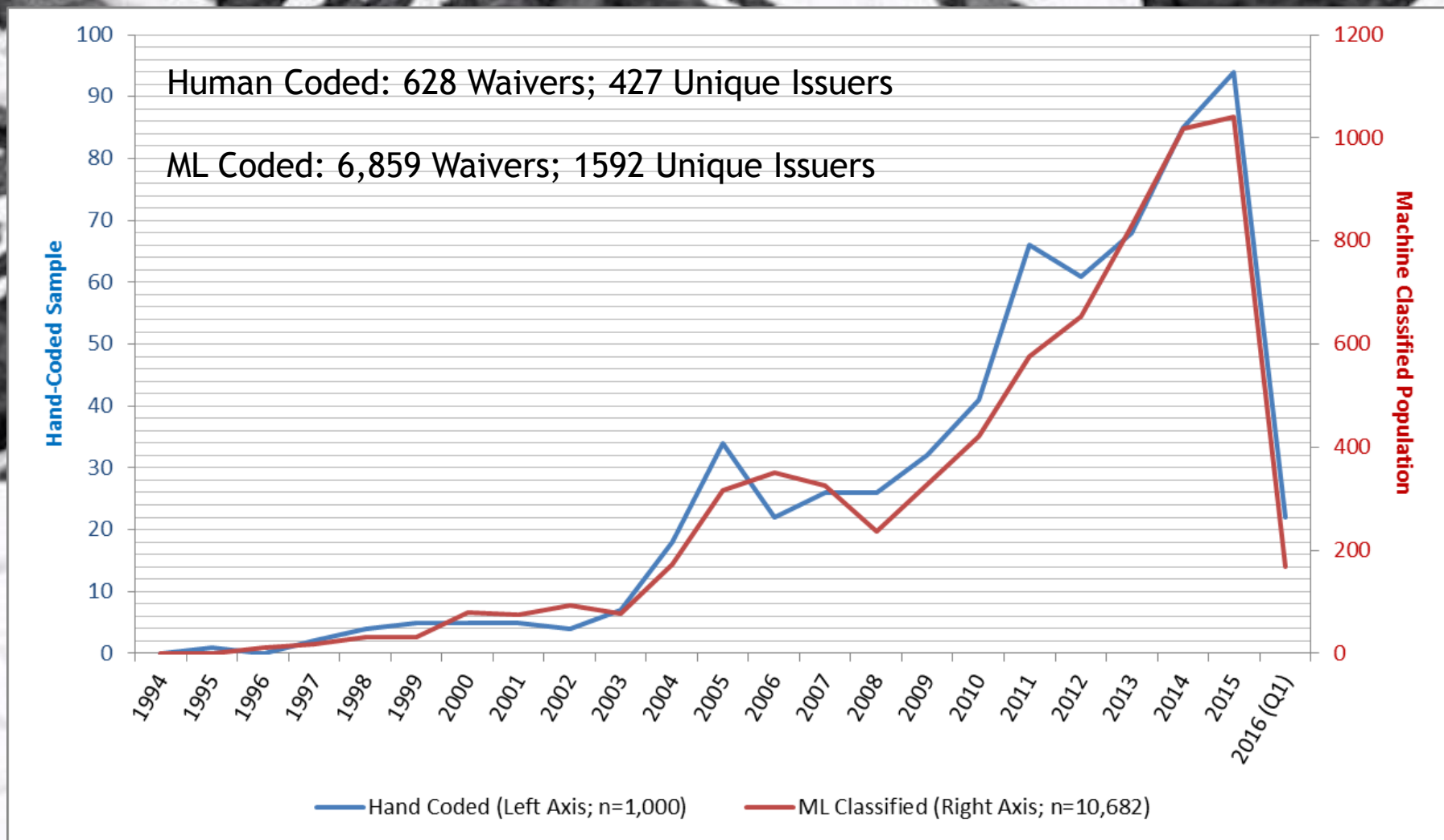
- ▶ Essentially, in the context of modern corporate structures, fiduciaries (either VC principals or controlling shareholders) may sometimes be more efficient appropriators of new business opportunities than the firms of which they are fiduciaries

Methodology: Build an original data set from textual disclosures

Significant Empirical Challenge: *Where to look?*

Enabling statutes do not prescribe in detail how/where to execute/disclose a COW. (Could be disclosed/described in nearly any publicly filed document).

- ▶ We combed through all SEC filings using a liberal Boolean key-word search to flag “candidate” COW disclosures.
 - ▶ ~24,000 hits, of which 10,682 were unique snippets
- ▶ From these, we randomly sampled 1,000 candidates for detailed hand coding
 - ▶ Substantial training; cross-validation; multi-dimensional coding rubric (see next slide)
 - ▶ Around 63% of sample were deemed to contain either an operative waiver or a discussion of a waiver
- ▶ We then used hand-coded sample to “train” a machine-learning (ML) classifier to code the remaining snippets
 - ▶ Details at end, time permitting. (But we think it’s pretty cool)



COW sightings

By Year

Where COW disclosure was found

<i>Location of Waiver</i>	<i>Operative Provision</i>	<i>Discussion of Waiver</i>	<i>% of COWs</i>
Charter	169	337	72.22%
Bylaws	5	10	2.21%
Board resolution	1	11	0.42%
Other	59	41	25.21%

Table 1: Location of COW in Corporate Governance Documents

Waivers in Sample exhibit broad scope and reach...

<i>Scope of Waiver</i>	<i>Operative Provision</i>	<i>Discussion of Waiver</i>	<i>% of COWs</i>
All Corporate Opportunities	108	155	46.15%
“All but” Certain Corporate Opportunities	100	227	42.73%
Specified Corporate Opportunities	34	97	14.53%

Table 2: Scope of Waiver

<i>Reach of Waiver</i>	<i>Operative Provision</i>	<i>Discussion of Waiver</i>	<i>% of COWs</i>
Officer(s) ^[1]	115	194	49.14%
Director(s) ^[2]	172	278	73.50%
Shareholder(s) ^[3]	123	115	52.56%

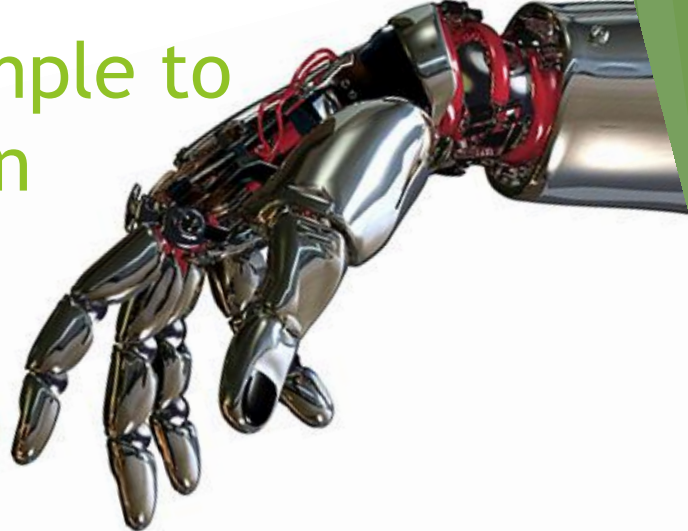
[1] This category blends: *all officers, any officers, or enumerated officers* covered by the COW.

[2] This category blends: *all directors, any directors, or enumerated directors* covered by the COW.

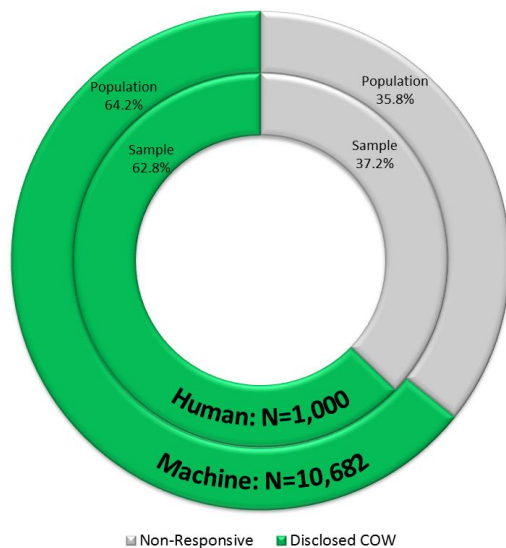
[3] This category blends: *all shareholders, any shareholders, or enumerated shareholders* covered by the COW.

Table 3: Corporate Fiduciaries Covered by COW

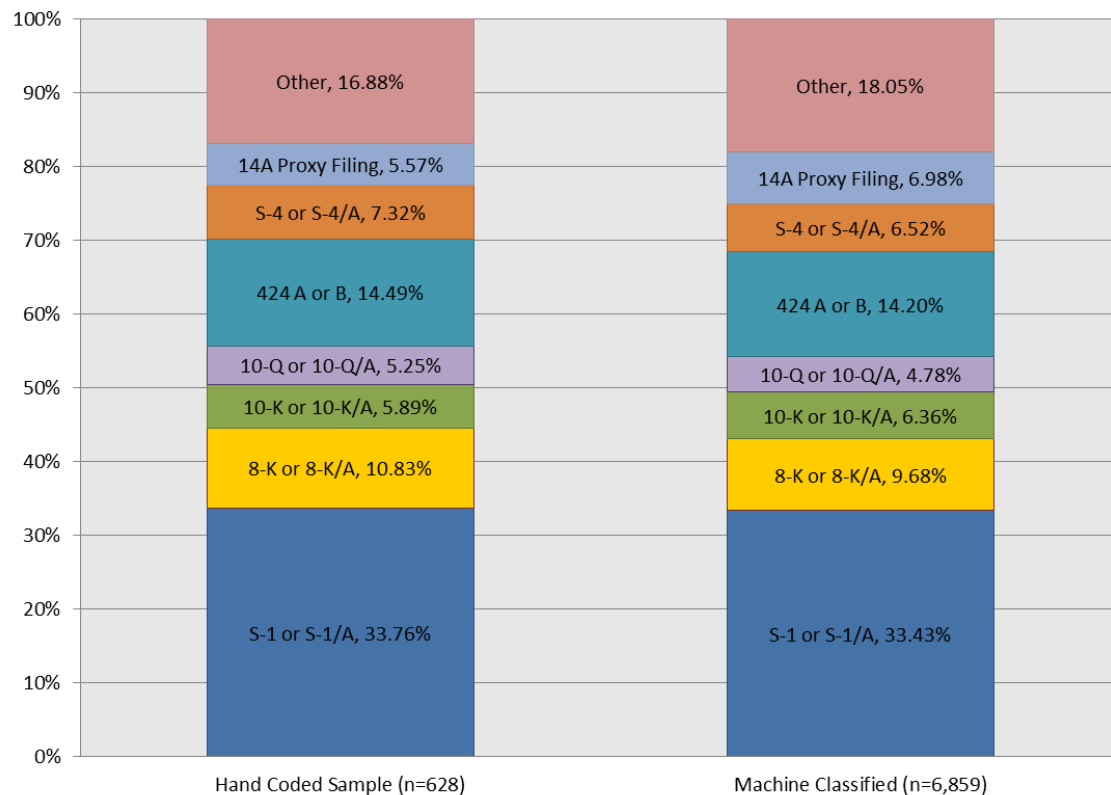
Comparing Training Sample to ML Classified Population



Human- v. ML-Classified COW Detection Rate
Human=Inner Circle; Machine = Outer Circle



Location of COWs in Issuer Filings: Relative Frequencies



COW disclosers tend to exhibit relatively strong performance metrics

TABLE 6a: All Entities

	Hand-Coded Matches				ML-Classified Matches				Compustat Universe			
	<i>N</i>	<i>Mean</i>	<i>Median</i>	<i>St. Dev.</i>	<i>N</i>	<i>Mean</i>	<i>Median</i>	<i>St. Dev.</i>	<i>N</i>	<i>Mean</i>	<i>Median</i>	<i>St. Dev.</i>
<i>Total Assets</i>	363	6,563.12	1,200.27	22,876.52	1,695	6,490.38	976.27	26,290.51	245,617	10,111.37	255.26	91,205.30
<i>Total Liabilities</i>	362	5,290.97	731.83	20,507.36	1,693	4,675.83	571.29	19,330.04	245,239	8,726.75	129.02	86,064.63
<i>Long-Term Debt</i>	362	1,456.51	359.55	3,378.95	1,692	1,555.30	271.64	4,042.57	245,110	1,698.17	13.05	27,924.00
<i>Revenues</i>	361	2,034.32	628.20	5,156.28	1,677	2,949.80	500.39	18,250.64	244,390	2,149.86	94.05	11,022.27
<i>CapX</i>	356	163.69	27.19	428.19	1,660	275.32	26.06	1,659.62	206,328	166.36	3.75	1,056.67
<i>EBITDA</i>	344	303.54	117.59	687.83	1,619	538.59	90.46	2,904.05	212,647	406.82	10.31	2,441.16
<i>ROA (Winsorized 0.05)</i>	344	2.42%	8.63%	27.19%	1,619	1.70%	8.68%	27.02%	211,781	-4.41%	6.35%	34.15%
<i>Tobin Q (Winsorized, 0.05)</i>	294	184.73%	123.45%	187.96%	1,278	186.79%	124.96%	182.04%	156,774	177.52%	97.30%	223.90%

TABLE 6b: Delaware Corps

	Hand-Coded Matches				ML-Classified Matches				Compustat Universe			
	<i>N</i>	<i>Mean</i>	<i>Median</i>	<i>St. Dev.</i>	<i>N</i>	<i>Mean</i>	<i>Median</i>	<i>St. Dev.</i>	<i>N</i>	<i>Mean</i>	<i>Median</i>	<i>St. Dev.</i>
<i>Total Assets</i>	313	6,706.80	1,200.27	23,700.48	1,385	4,924.20	917.79	16,619.59	99,539	7,341.69	222.51	67,962.44
<i>Total Liabilities</i>	312	5,399.06	758.16	21,208.74	1,383	3,674.69	574.19	13,686.53	99,310	6,160.65	107.82	61,627.58
<i>Long-Term Debt</i>	312	1,516.95	384.53	3,556.15	1,382	1,481.94	275.83	3,815.57	99,218	1,228.49	11.79	10,174.31
<i>Revenues</i>	311	2,201.04	658.18	5,499.77	1,369	2,078.33	572.54	4,887.12	99,087	1,998.26	130.13	10,066.51
<i>CapX</i>	308	162.42	30.96	433.75	1,360	196.66	28.40	548.02	88,288	131.00	4.78	847.70
<i>EBITDA</i>	304	313.05	120.92	710.76	1,348	367.32	93.53	1,062.69	90,989	324.88	11.51	1,982.01
<i>ROA (Winsorized 0.05)</i>	304	3.20%	8.81%	25.26%	1,348	1.75%	8.89%	26.84%	90,719	-4.62%	7.21%	34.51%
<i>Tobin Q (Winsorized, 0.05)</i>	258	187.71%	125.32%	187.93%	1,079	191.44%	127.63%	185.05%	64,210	194.53%	114.10%	220.18%

Event Study: Mkt response to 1st COW disclosure (training sample n=83)

Must be able to estimate asset-pricing model in “pre” disclosure time frame

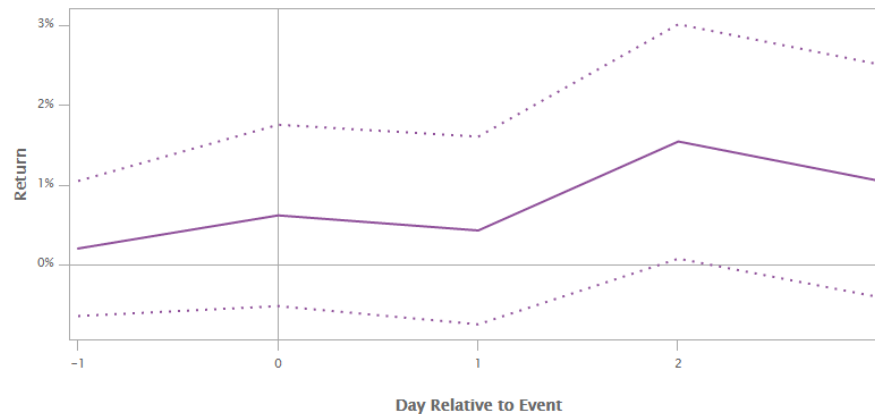


Figure 5: Mean Cumulative Abnormal Return of COW Disclosers (solid line) and 95% Confidence Interval (dashed line)

Asset Pricing Model (n=83)	Event Window (Cow Disclosure = 0)		
	(-1,+1)	(-1,+2)	(-1,+3)
Market-Adjusted Returns	0.47%	1.57%	1.03%
	0.974	2.118**	1.205
CAPM (Value Weighted Index)	0.24%	1.26%	0.72%
	0.913	1.972**	1.145
Fama French 3-Factor Model	0.30%	1.21%	0.69%
	0.378	1.318	0.677
Fama-French-Carhart 4-Factor Model	0.31%	1.34%	0.84%
	0.396	1.462	0.817

Table 7: Cumulative Abnormal Returns on first COW disclosure (n=83)

Interpretational Challenge

- ▶ While first-announcement event study *may* reflect positive reception to COWs *per se*...
- ▶ ...a COW disclosure is almost always accompanied by other newsworthy disclosures that likely plausibly trigger market reactions:
 - ▶ Spin-offs & Equity carve-outs
 - ▶ Asset sales
 - ▶ New prominent investors
 - ▶ Attracting high-quality managers
- ▶ Likely that COW disclosure occurs contemporaneously with newsworthy announcement accompanying it
 - ▶ This may not be a bug as much as a feature, however
- ▶ May be worth checking results against effects against contexts where such bundling conflation is less likely to be a first-order concern.
 - ▶ Initial promulgation of COW-enabling statute?