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Conflict of Interest in the Board Room - Misconduct "Market Discipline" Cannot Kill

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Misconduct “Market Discipline” Cannot Kill

by Jayne W. Barnard

Just as in hemlines, there are fashions in legal scholarship. One of the current trends emanating from the “Chicago school” of law and economics is the belief that “market forces” serve as an adequate deterrent to conflict of interest transactions by corporate executives.

This view is held not only by academics, who might otherwise be forgiven, but has been adopted by influential federal judges and at least one member of the Securities and Exchange Commission. The theory, briefly stated (usually, a 20-page heavily footnoted law review article is required), is that a constellation of market forces disciplines corporate directors and officers so that they do not seek undue personal gain while managing their businesses.

To these theorists, the world is made up of markets. First, there is a market for goods and services, where companies shop for the stuff which makes companies go. Second, there is market for capital, where companies shop for money and investors willing to put their finances at risk. There is also a market for managerial labor, where companies shop for high level executives, and most significantly, where managers shop for high level jobs.

How do these markets operate to alter human nature? Well, say the theorists, if managers extract too much personal gain from the business, either in the form of excess compensation or through self-dealing business relationships, the value of the firm will be diminished and the market for capital will close down – lenders and investors will not be willing to infuse growth money and the managers will therefore find themselves in a stagnant business. Thus, managers have a strong incentive to curb their short-term opportunistic instincts, so that their businesses will grow and provide them with greater wealth in the long term.

Alternatively, the Chicagoans say, managers regard themselves as commodities tradeable in the market for managerial labor, where the best jobs are a scarce and highly desirable resource. If managers are to position themselves to trade upward for a better opportunity in Job #2, they must first maximize shareholder wealth in Job #1. Since excessive self-dealing is inconsistent with shareholder wealth, ambitious managers will not engage in conflicts of interest, thus (1) limiting the likelihood that their businesses will become takeover targets and (2) enhancing their long term chances for a better job.

Moreover, this market discipline is enforced both by co-managers and by subordinate employees, all of whom, recognizing that their optimum compensation potential is earnings-based, have shareholder wealth as their predominant goal.

Anyone who has spent any time around business executives will of course respond, “Phooey.” And recent empirical research confirms that the world does not operate as the theorists would predict – that
business executives in a position to do so in fact chronically and repeatedly structure their corporate dealings to enhance their immediate personal or family gain. In both privately held and publicly held businesses, the existence of one or more “material conflict of interest transactions” each year is the rule, rather than the exception.

One might not find this surprising in non-publicly held enterprises. After all, one reason entrepreneurs incorporate is to maximize personal gain while minimizing personal risk. So when the Wall Street Journal reported that, while Crazy Eddie, Inc. was still a private company, Eddie Antar, its principal shareholder and CEO, had “virtually [used] the company as a private bank,”* granting himself $470,000 in interest-free loans, paying various family members $75,000 annual stipends, extending millions of dollars of credit to a son-in-law’s business venture (supplying cassettes to Crazy Eddie) and guaranteeing the six-digit (never repaid) borrowings of still another relative, it was no great shock. “Sure there were a lot of third-party dealings and tax shelters,” said a company spokesman. “As a private corporation, Eddie’s wasn’t dedicated to enriching the coffers of the Internal Revenue Service.” So long as the IRS didn’t complain, “Crazy” Eddie Antar was not only not crazy, he was just playing the All-American game of grabbing everything he could grab.

But what of those publicly-held companies where the managers, in theory at least, work for shareholders other than themselves and are thus subject to the soul-cleansing (or at least conduct-limiting) market forces extolled by the Chicago school? Do conflicts of interest transactions occur there too? Anecdotal evidence is abundantly in the affirmative.

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Item: DeLaurentiis Entertainment Group, which went public in 1986, and is now deep in debt – its movie library and production studio on the block to pay off its bankers – is still run as if it were private. Its CEO, famed director Dino DeLaurentiis, hired his daughter as head of production (annual salary $400,000), and his girlfriend as head of the studio. According to Forbes Magazine, he also authorized production deals with his son-in-law, a videocassette deal in Spain and Portugal with a second son-in-law and a distribution deal with a brother in Italy. DEG made $27 million in loans (as yet unrepaid) to two private companies owned by the DeLaurentiis family, and another of $8.4 to DeLaurentiis himself.

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Item: The directors of Allegheny International – once a Fortune 500 company, now in Chapter 11 – have been named in a shareholders’ suit alleging that they approved for themselves and several AI executives $32.3 million in low-interest (2%) loans; that they approved “without any valid business purpose” a $16 million purchase of a controlling interest in a failing Florida condominium complex in which former Chairman Robert J. Buckley and other top AI officers had substantial financial interests; that they caused the company to purchase a multimillion dollar hotel and install as its manager (and resident of a $1 million penthouse suite) Buckley’s son, who had no hotel experience; and that they permitted other excesses, including the maintenance of a multiple-jet “Allegheny Air Force” for frequent executive personal use and at least two fancy homes – a “magnificent” Tudor mansion in one of Pittsburgh’s best neighborhoods (cost after furnishing, nearly $1 million) and a resort condominium bordering an exclusive golf course (cost approximately $500,000) – ostensibly used for “dignitary” entertainment, but frequently used for Buckley’s personal enjoyment.

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Item: Horn & Hardart Co., a food service conglomerate which lost $28.4 million in FY 1986, has been involved in a number of conflict of interest transactions in recent years with Barry Florescue, its Chairman and CEO, and Donald Schupak, vice chairman. Lear TCB, Inc., which is jointly owned by Florescue and Schupak, has charged Horn & Hardart $1.2 million since 1984 for use of two corporate jets. Shareholders have challenged Florescue and Schupak’s sale to Horn & Hardart of two regional Bojangles franchise holding companies for $1 each plus assumption of $8.5 million in liabilities, claiming the acquisition amounts to a waste of corporate assets. Florescue-controlled entities own the property and collect substantial rents annually for eight of Horn & Hardart’s restaurant sites and an office facility.

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Item: Mobil Oil Co. president and CEO William Tavoulareas has gained considerable notoriety for Mobil’s multi-million dollar no-bid deals with Atlas Maritime Co., an international shipping company in which Tavoulareas’s son Peter was a principal. Tavoulareas’s libel suit against the Washington Post for reporting that he had “set [Peter] up” in the venture was recently dismis-
ized by the U.S. Court of Appeals, with the observation that the facts surrounding the various Atlas transactions reflected an "[abundance of] evidence of nepotism in favor of Peter."

It is by no means clear that all, or even any, of the conflict of interest transactions described above impacted adversely on share value or were, in the sense that reviewing courts construe the term, "unfair" to the involved corporations. What enriched the executives may also have benefitted their companies. But it is clear that, in these widely-traded closely-scrutinized public companies, where the Chicagoans' "market forces" presumably work most efficiently, conflicts of interest - some highly suspect - were still present.

I recently dug more deeply to discover the extent to which conflict of interest transactions occur in business. Using documents filed with the Securities and Exchange Commission during June 1986, I reviewed the disclosure statements of 44 companies about to go public for the first time. Of those 44 companies, 43 of them (or 97.7%) had engaged during the preceding three years in business transactions in which their officers or directors had received benefits at least $60,000 in excess of their routine compensation. Seventeen (38.6%) had rented office space or equipment from entities controlled by their executives. Nineteen (43.2%) had made substantial loans to their executives, mostly at below-market rates and seldom secured. Twenty-two (50%) had paid consulting fees to outside directors for services ranging from investment banking to lawyering to advertising copywriting. Twenty-four (54.5%) had engaged in other types of conflict of interest transactions, including the sale of franchises, supply contracts, the guaranty of business loans, office sharing arrangements, technology licensing agreements and the sale of property.

Some of these companies were undoubtedly so closely held as to invoke the "Crazy Eddie" defense, but others were not. Companies with several hundred shareholders can still, under SEC guidelines, be "non-public."

The news was not much better for the publicly-held companies. I reviewed the 1986 filings for 48 such companies and found that, of them, 37 (77%) had engaged during their most recent operating year in reportable conflict of interest transactions. Seventeen (35.4%) had leased property from their managers; eight (16.7%) had made below-market loans; sixteen (33.3%) had paid substantial consulting fees to their outside directors and 21 (43.8%) had found other ways to provide special enrichment to their officers and directors or their families.

The amounts involved in these deals were not peanuts either. In the private companies, annual rental payments to insiders ran as high as $982,000 annually; "consulting fees" ranged as high as $606,000 and executive loans reached $339,000. In the publicly-held companies, consulting fees ran to $2,462,008 and below-market executive loans as high as $840,000.

Can it be merely a coincidence that the managers of these businesses so frequently found the best real estate deal in town right in their own board room? That the most accomplished lawyer (or financial consultant, or public relations consultant or insurance broker or "safety and protection devices" consultant) was a member of their own management team? That the best investment to be found paying the highest return turned out to be a below-market unsecured loan made to one of their own executives?

What's wrong with this picture? If it is true that the markets for capital and for managerial labor work as efficiently as the Chicago schoolers seem to think, then it must be the market for goods and services which is out of whack - a heretical thought.

It may just be that the marketeers of the Midwest are wrong in their theory. In fact there are many forces less esoteric than "market" forces which operate to limit conflicts of interest in business — IRS rules, SEC rules and state rules requiring approval of self-dealing transactions by "disinterested" members of the board. The problem is, human nature being what it is, none of them seems to work.

"All my life people have been coming to me with plans to make over society and its institutions. Many of these plans have seemed to me good. Some of them have been excellent. All of them have had one fatal defect. They have assumed that human nature would behave in a certain way. If it would behave in that way almost any one of these plans would work, but if human nature would behave in that way not any of the plans would be necessary, for in that case society and its institutions would naturally reform themselves to perfection."

- Elihu Root