

Be Careful What You Wish For: How Progress Engendered Regression in Related Party Transaction Regulation in Israel

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Abstract

The regulation of related party transactions (RPTs) is today the single most important yardstick for the quality of corporate governance systems. It is also one of the thorniest issues because RPTs are a well-documented cause of abuse by corporate insiders, yet they could be valuable and sometimes simply inevitable. This paper analyzes reform measures adopted in Israel with a view to improving corporate governance in general and RPT regulation in particular. Whereas one set of measures revolved around procedural safeguards based on disinterested informed approval (a property-like rule), another set purported to establish a Delaware-like business court that would implement an “entire fairness” review (a liability-like rule). The latter trend came to dominate the former notwithstanding applicable statutory and case law, thus engendering regression instead of progress in RPT regulation. This case suggests lessons for law makers, be they judges or legislators, who contemplate mimicking the “corporate capital of the world”.

Keywords: corporate governance, related party transactions, fiduciary duties, property rule, liability rule, specialized court

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The regulation of related party transactions (RPTs) is today the single most important yardstick for the quality of corporate governance systems. It is also one of the thorniest issues because RPTs are a well-documented cause of abuse by corporate insiders, yet they could be valuable and sometimes simply inevitable. This paper analyzes reform measures adopted in Israel with a view to improving corporate governance in general and RPT regulation in particular. Whereas one set of measures revolved around procedural safeguards based on disinterested informed approval (a property-like rule), another set purported to establish a Delaware-like business court that would implement an “entire fairness” review (a liability-like rule). The latter trend came to dominate the former notwithstanding applicable statutory and case law, thus engendering regression instead of progress in RPT regulation. This case suggests lessons for law makers, be they judges or legislators, who contemplate mimicking the “corporate capital of the world”.

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1. INTRODUCTION

This paper recounts a rapid deterioration in Israeli company law with regard to corporate action tainted by insiders' interest. Within just a few years, Israeli law shifted from conditioning tainted corporate actions, including related party transactions (RPTs), on a fully-informed-consent mechanism to apparent tolerance of such actions, provided that they appear appropriate to the court upon review of their substantive business rationale. This process took place largely after the establishment of a specialized business division within the Tel Aviv District Court, purportedly with a view to mimicking Delaware's courts, notwithstanding applicable case law that had adopted a "no further inquiry" approach to potentially conflicted transactions. This case thus provides a sobering lesson: a well-intentioned corporate governance reform carried out by well-meaning judges could beget regression rather than progress.

The regulation of corporate RPTs is a focal issue in corporate governance circles. Because of RPTs' pernicious tendency to serve as a vehicle for extraction of value from firms they have come to epitomize corporate governance ills.¹ A more general conceptualization in the law and finance literature focuses on the legal protection of public shareholders against abuse by corporate insiders. This protection is taken today to reflect the quality of corporate governance in countries and firms alike. Tellingly, the prominent quantitative index of legal shareholder protection and corporate governance quality focuses on "anti-self dealing" and no longer on "anti-director rights".² Beyond methodological improvements over its predecessor, the

¹ See, e.g., Vladimir Atanasov, Bernard Black, & Conrad Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1 (2011). The tunneling metaphor for hollowing out firms comes from Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. (PAPERS & PROC.) 22 (2000).

² Compare, respectively, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008); Rafael La Porta,

anti-self-dealing index by Djankov *et al.* is more directly anchored in agency theory and is better moored to a key challenge that every corporate governance system faces, which is to optimize RPT regulation.³ Another approach to assessing corporate governance systems focuses on control premiums. This approach, too, assumes that a major factor affecting such premiums is the likelihood of extracting private benefits of control through RPTs.⁴

Specialized courts feature prominently as a potent mechanism for helping business and especially for facilitating legal enforcement of corporate governance rules. Such courts have mushroomed both within the United States and in countries around the world.⁵ Delaware's courts lead the pack by a large margin; in particular, its Chancery Court. The recipe for Delaware's success as the "corporate capital of the world" remains secret, however, and is subject to academic debate.⁶ As it happens,

Florencio Lopez-de-Silanes, & Andrei Shleifer, *Law and Finance after a Decade of Research*, in HANDBOOK OF THE ECONOMICS OF FINANCE, vol. 2A 425 (George Constantinides, Milton Harris, & Rene M. Stulz eds. 2013), with Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

³ See, generally, Holger Spamann, *Empirical Comparative Law*, 11 ANN. REV. L. & SOC'L SC. 131 (2015).

⁴ See, e.g., Michael J. Barclay & Clifford G. Holderness, *Private Benefits From Control of Public Corporations*, 25 J. FIN. ECON. 371 (1989); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004); Ronen Barak & Beni Lauterbach, *Estimating the Private Benefits of Control from Partial Control Transfers: Methodology and Evidence*, INT'L J. CORP. GOVERNANCE 683 (2011).

⁵ See Jens Dammann, *Business Courts and Firm Performance*, working paper (2017); Stefano Colonnello & Christoph Herpfer, *Do Courts Matter for Firm Value? Evidence from the U.S. Court System*, working paper (2016); Matthieu Chemin, *Does Court Speed Shape Economic Activity? Evidence from a Court Reform in India*, 28 J. L. ECON. & ORG. 460 (2012); John F. Coyle, *Business Courts and Interstate Competition*, 53 WM. & MARY L. REV. 1915 (2012); Lee Applebaum, *The Steady Growth of Business Courts*, in FUTURE TRENDS IN STATE COURTS 2011 70 (Carol R. Flango et al. eds., 2011); see generally Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 BROOK. L. REV. 1 (1995).

⁶ See Brian J. Broughman, Jesse M. Fried, & Darian M. Ibrahim, *Delaware Law as Lingua Franca: Theory and Evidence*, 57 J. L. & ECON. 865 (2014); Robert Anderson IV & Jeffery Manns, *The Delaware Delusion*, 93 N.C. L. REV. 1049 (2015); Omari Scott Simmons, *Delaware's Global Threat*, J. Corp. L. (Forthcoming); see also Adam B. Badawi & Daniel Chen, *The Shareholder Wealth Effects of Delaware Litigation*, working paper (2015); Stefano Colonnello & Christoph Herpfer, *Do Courts Matter for Firm Value? Evidence from the U.S. Court System*, working paper (2016); Jill E. Fisch, *The*

Delaware's chancery is not a business court by design. It is actually a 200-years old institution exercising limited equitable jurisdiction with hardly any parallel still operating in other places today.⁷ That does not prevent Delaware's chancery from being a major factor in its dominance in U.S. corporate law in recent generations.⁸ Suffice is to say that in addition to understanding business needs its chancellors and judges are exceptionally able lawyers. While attempts to replicate Delaware's courts in other states and countries have proved challenging,⁹ scholars recommend establishing commercial courts to regulate controlling shareholders' private benefits of control.¹⁰

Because social institutions are closely interrelated and tend to exhibit path dependence, there does not exist a silver bullet that would provide a quick fix for a corporate governance system in need of repair.¹¹ Combining reforms of different elements in the system, even if partial and imperfect in isolation, could achieve substantial improvement. Armour and Schmidt thus argue that in Brazil, a new array

Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. CIN. L. REV. 1061 (2000).

⁷ See William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery, 1772-1992*, 18 DEL. J. CORP. L. 819 (1993).

⁸ See William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 BUS. LAW. 351 (1992–1993); Randy J. Holland, *Delaware's Business Courts: Litigation Leadership*, 34 J. CORP. L. 771 (2009); see also Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 IOWA L. REV. 465 (2015); Omari Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129 (2008); Larry E. Ribstein & Erin Ann O'Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661 (2008).

⁹ See Appelbaum, *supra* note 5; Joseph A. McCahery & Alexander de Roode, *Corporate Litigation in Specialized Business Courts*, working paper (2016); Joseph A. McCahery & Erik P. M. Vermeulen, *Conflict Resolution and the Role of Courts: An Empirical Study*, in COMPANY LAW AND SMES 207 (Mette Neville & Karsten Engsig Sorensen eds. 2010); Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. 765 (2002).

¹⁰ See Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review*, 169 J. INSTITUTIONAL & THEORETICAL ECON. 160 (2013).

¹¹ See HENRY HANSMANN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 39-42 (2017).

of overlapping specialist enforcement institutions, including panels of expert commercial judges in the São Paulo Court of Justice, together form a mutually reinforcing system of enforcement.¹² These authors argue that this system is more capable than its unpromising judicial foundations and helps to ameliorate uncertainties that stem from Brazil's Civil Code, the lack of formal precedents, and a clogged judicial system. These initiatives should be considered in connection with other projects that have made Brazil a testing ground for corporate governance reforms - in particular, experimenting with market-based regulatory dualism in the São Paulo Stock exchange, which offered voluntary elite listing to companies willing to comply with more stringent corporate governance rules, among other things - with regard to RPTs.¹³ The Israeli reform process discussed in this paper resembles the Brazilian experience in certain ways yet differs from it in important respects. It thus provides a valuable perspective for evaluating reforms in RPT regulation and in corporate governance systems more broadly.

Beginning in the early 1990s and through the 2010s, Israel carried out a series of legal reforms with a view to modernizing its corporate governance infrastructure. These reforms included a brand new company law statute, several amendments to the securities laws, major capital market reforms affecting institutional investors and other financial institutions, and establishing new courts, primarily the Tel Aviv

¹² See John Armour & Caroline Schmidt, Building Enforcement Capacity for Brazilian Corporate and Securities Law. European Corporate Governance Institute (ECGI) Law Working Paper No. 344/2017 (2017).

¹³ Additional rules deal with voting rights, disclosure, and mandatory bids. See Ronald J. Gilson, Henry Hansmann, & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475 (2011); Antonio Gledson de Carvalho & George G. Pennacchi, *Can a Stock Exchange Improve Corporate Behavior? Evidence from Firms' Migration to Premium Listings in Brazil*, 18 J. CORP. FIN. 883 (2012); Érica Gorga, *Corporate Control and Governance after a Decade from "Novo Mercado": Changes in Ownership Structures and Shareholder Power in Brazil*, in Research Handbook on Shareholder Power 479 (Jennifer G. Hill and Randall S. Thomas, eds. 2015).

District Court's Economic Division. These changes were implemented in a predominantly common law jurisdiction with largely functioning courts. The legislative reforms of company law introduced a new approval mechanism for RPTs in publicly traded companies that was based on disinterested decision makers in the company. After several changes that are described in more detail below, by 2011, Israeli law had in place a full-fledged majority-of-the-minority (MoM) approval requirement for transactions tainted by a controlling shareholder's interest, in line with the most advanced OECD recommendations for RPT regulation.¹⁴

These measures were innovative but not revolutionary. Israeli law had long recognized the “no further inquiry” doctrine on fiduciary self-dealing, which makes the tainted action voidable at the behest of the beneficiary regardless of its substantive terms. In addition to several statutory provisions that reflect this doctrine, the Supreme Court of Israel implemented the seminal case of *Aberdeen Railway Co. v. Blaikie Brothers* with regard to company directors.¹⁵ Notwithstanding its fundamental importance in fiduciary law in general and in corporate RPT regulation in particular, this doctrine has been ignored by Economic Division judges and also by the Supreme Court justices, in clear contradiction with earlier precedents. Inspired by Delaware jurisprudence and strongly motivated to mimic its courts, recent Israeli courts instead have voiced growing support for substantive judicial review of RPTs according to their “entire fairness”. A related line of dicta furthermore called for implementing Delaware's standards-of-review approach. This process culminated in a 2016 decision in *Vrednikov v. Elovitch*,¹⁶ in which the Supreme Court held that a

¹⁴ OECD, RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER RIGHTS (2012).

¹⁵ [1854] UKHL 1, (1854) 1 Macq 461 (H.L.).

¹⁶ C.A. 7735/14 *Vrednikov v. Elovitch* (28.12.2016) (Isr.) (“*Vrednikov Appeal*”).

corporate action potentially tainted by a controlling shareholder's interest affecting the directors should be reviewed according to an intermediate "enhanced scrutiny" standard, such that the burden shifts to the directors to show that their decision was reasonable. That decision was later drastically narrowed but not overruled.

Within less than six years Israeli law thus moved from the classic, property-rule doctrine on (potentially) conflicted corporate transactions that depends on a fully-informed approval by disinterested decision makers to a liability-rule approach that can be satisfied with the tainted action being fair or even just reasonable. Put otherwise, controlling shareholders were granted an option to effect potentially conflicted RPTs at an exercise price of fair or reasonable market rate. This process of legal deterioration in twenty-first century Israel bears some resemblance to a legal transformation that took place in the United States during the late nineteenth and early twentieth centuries, which gave rise to the Entire Fairness doctrine. That many a scholar deplore this doctrine apparently was lost on the Israeli judges who exhibited unquestioning conviction that the Delaware appellation stands for better law.

The paper proceeds as follows. Part 2 provides a brief background on regulating self-dealing, especially with a property-rule regime. Part 3 details the path of the law in Israel during its formative years and during recent time. Part 4 concludes by putting the Israeli experience in a broader context.

2. POWER, PROPERTY, AND FAIRNESS

2.1. A Necessary Evil?

Related party transactions in companies are a particular case of fiduciary action in the presence of a (real, sensible possible) conflict of interests or of a foreign consideration. In many cases, though not always, RPTs are simple, brute self-

dealings. Granted, directors selling a widget to their company could be distinguished from controlling shareholders doing the same with the consent of the directors they elected. Among other things, controlling shareholders are not fiduciaries per se although some jurisdictions may treat them as such, at least in certain circumstances. One could draw fine distinctions between the above categories, and certain courts do so at times. Here, however, I will assume that these situations overlap conceptually and consider differences between them as of secondary importance. These settings share a common theme - namely, that the discretion of the company's agents might not be exercised in good faith; it could be clouded by self-interest or by the interest of another. These agents would be in breach of their fiduciary duty to the company.

A well-known dilemma thus arises.¹⁷ On the one hand, allowing RPTs to go forward puts the company at risk that its fiduciaries may abuse their power over it - in particular, due to their informational superiority. On the other hand, a flat ban on RPTs for fear of abuse of fiduciary power likely will lead to losing mutually beneficial transactions and hence to social loss. In many situations, moreover, an RPT cannot be avoided such that the law must design some regulation for it - e.g., when promoters contribute essential resources to the company upon its establishment or when shareholders of a company in financial distress support it by extending credit at below-market rate.

¹⁷ For a lucid discussion *see*, e.g., ROBERT C. CLARK, *CORPORATE LAW* 142-147 (1986). *See also* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 *YALE L.J.* 560 (2016); Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges with a Critique of the European Commission Proposal*, 16 *EUR. BUS. ORG. L. REV.* 1 (2015); Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 *J. CORP. L.* 681 (2008); Ronald J. Gilson & Jeffery N. Gordon, *Controlling Controlling Shareholders*, 152 *U. PA. L. REV.* 785 (2003); Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 *CAL. L. REV.* 393 (2003). María Gutiérrez & María Isabel Sáez, *A Contractual Approach to Disciplining Self-Dealing by Controlling Shareholders*, 2 *J. L. FIN. & ACCT.* 173 (2017) advance a nuanced formal analysis.

Since a strict prohibition of RPTs is neither viable nor desirable, the focus shifts to the optimal mode of screening and sanctioning RPTs. The law and economics literature has embraced different analytical frameworks for addressing this subject.¹⁸ Goshen has harnessed Calabresi and Melamed's distinction between property rules and liability rules.¹⁹ In this view, conditioning the RPT on an *ex ante* approval by non-related corporate parties reflects a property rule. When a controlling shareholder is involved, the more stringent mechanism would require an MoM approval. In contrast, an *ex post* judicial review of the transaction's appropriateness reflects a liability rule. Gutiérrez and Sáez rely on the rules-versus-standards distinction to analyze the relative efficiency of approval rules and litigation rules, respectively.²⁰

2.2. Fully-Informed Consent

Option theory provides a useful framework for conceptualizing the problem underlying RPTs.²¹ When a legal relationship between an owner of a certain entitlement and another person is subject to a liability-rule regime (which may or may not overlap with a litigation-rule regime), the latter person can take that entitlement from its owner, regardless of her consent or objection to it, subject to paying a proper

¹⁸ For reasons of scope I abstract from other normative frameworks. Interestingly, outside the circle of law and economics one tries hard, perhaps in vain, to find an analytical discussion of (corporate) self-dealing that does not condemn it outright. The situation may be different, however, with regard to groups of companies in Europe. See generally Klaus J. Hopt, *Groups of Companies: A Comparative Study of the Economics, Law, and Regulation of Corporate Groups*, IN THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey N. Gordon & Wolf-Georg Ringe, eds. 2015), DOI: 10.1093/oxfordhb/9780198743682.013.30. I am grateful to Luca Enriques for this observation.

¹⁹ See, respectively, Goshen, *ibid.*; Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

²⁰ See, respectively, Gutiérrez & Sáez, *supra* note 17; Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992). One might be tempted, but should resist the temptation, to move to a higher level of abstraction by invoking Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

²¹ See, generally, IAN AYRES, *OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS* (2005). On financial options see RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 503-505 (10th ed. 2011).

(“fair”) price as defined *ex post* by a court. A liability-rule regime thus grants the other person the power to unilaterally decide who will eventually own that entitlement. This option could be either a call or a put option, depending on whether the other person wants to expropriate a coveted widget from its owner or to impose on him a widget she no longer desires. In a common example for applying option theory to legal entitlements, contractual expectation damages reflect a liability rule that grants a call option on performance, namely, a right to redeem the obligation to perform against paying damages as the exercise price. In contrast, specific performance reflects a property rule in that it forces one to get the other party’s consent to non-performance.²² Most legal options of this kind resemble call options - namely, takings - yet certain legal interactions are akin to put options, leading Fennell to dub them “forcings”.²³ Property scholars seem to agree that the appropriate regime for property is, well, property rules.²⁴ These views share the insight that partial information, especially due to non-observability and non-verifiability in settings that involve uncertainty, could paralyze property institutions. Glaeser, Ponzetto, and Shleifer advance a more general analysis, arguing that property rules dominate

²² See George S. Geis, *An Embedded Options Theory of Indefinite Contracts*, 90 MINN. L. REV. 1664 (2006); Robert E. Scott & George G. Triantis, *Embedded Options and the Case against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004).

²³ See Lee Anne Fennell, *Forcings*, 114 COLUM. L. REV. 1297 (2014).

²⁴ See, e.g., Thomas W. Merrill & Henry E. Smith, *The Morality of Property*, 48 WM. & MARY L. REV. 1849 (2007); Henry E. Smith, *Institutions and Indirectness in Intellectual Property*, 157 U. PA. L. REV. 2083 (2009); Henry E. Smith, *Property as the Law of Things*, 125 HARV. L. REV. 1691 (2012); Abraham Bell & Gideon Parchomovsky, *Of Property and Information*, 116 COLUM. L. REV. 237 (2016); Lee Anne Fennell, *Revealing Options*, 118 HARV. L. REV. 1399 (2005); Amnon Lehavi, *The Property Puzzle*, 96 GEO. L.J. 1987 (2008); compare Ian Ayres, *Protecting Property with Puts*, 32 VAL. U. L. REV. 793 (1998).

liability rules when there are power differences between the parties, such that a property-rule regime promotes aggregate social welfare.²⁵

The above reasoning applies *a fortiori* to fiduciary relations. The beneficiary's interest is subject to the fiduciary's discretionary power, where the former suffers from acute informational inferiority vis-à-vis the latter, in addition to the already complex informational problem that characterize property. Fiduciary relations are formed precisely in order to take advantage of the fiduciary's superior skills and resources, provided that they are not abused. Protecting the beneficiary with a property-rule regime therefore is as compelling as the fact that the law rejects private expropriations. It is for this reason that a fiduciary "may not act for his own benefit or the benefit of a third person without the informed consent of his principal."²⁶ The situation is more complex, however, when the beneficiary is a corporation. The questions of how does a legal entity become fully informed and how can it form a valid consent to an RPT may be answered differently in various jurisdictions.²⁷ To date, the most advanced mechanism for protecting public companies and their public shareholders involves untainted²⁸ directors and an MoM approval.²⁹ Private companies usually implement simpler mechanisms but their underlying purpose is similar.

Several commentators nonetheless have argued that the law should tolerate fiduciary self-dealing as long as the court, with the assistance of lawyers and other

²⁵ See Edward L. Glaeser, Giacomo A.M. Ponzetto, & Andrei Shleifer, Securing Property Rights, NBER Discussion Paper DP11545 (2016).

²⁶ *Bristol and West Building Society v. Mothew* [1998] Ch 1, 18; see also *Crown Dilmun v. Sutton* [2004] 1 BCLC 468; *Commonwealth Bank of Australia v. Smith* [1991] FCA 375; Restatement (Third) of Agency § 8.06 (Am. Law Inst. 2005).

²⁷ For a critical review see Enriques, *supra* note 17.

²⁸ I use "untainted" to abstract from distinctions between "independent" and "disinterested", etc.

²⁹ See OECD, *supra* note 14.

professionals, can determine the facts about the tainted action.³⁰ Gilson and Schwartz thus aver: “An effective court commonly can recover the facts relevant to answering this question. 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.”³¹ Rock similarly believes that “judges can, with experience, become tolerably good at valuation” and that the Delaware Chancery Court judges have extended that expertise from the appraisal context to breaches of the duty of loyalty.³² Goshen and Hamdani argue that a controlling shareholder’s idiosyncratic vision deserves property-rule protection, whereas a liability-rule protection suffices for minority shareholders: “Given Delaware’s ecosystem of specialized courts and vibrant private enforcement, we find this approach desirable.”³³

Such views suffer from a weakness in that they assume away the problem. It does not matter how effective or skilled the court is with regard to information available to it, including thanks to “soft” skills of the sort that enable it to use a “smell

³⁰ See especially John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929 (2005).

³¹ Gilson and Schwartz, *supra* note 10, at 167. This article originated from a report the authors filed on behalf of certain Israeli pyramid groups that analyzed a proposed structural reform intended to curb corporate pyramids and controlling shareholders’ power. See Report of Professors Ronald J. Gilson and Alan Schwartz Concerning Recommendations of the Committee on Enhancing Competitiveness (2011), http://mof.gov.il/Committees/CompetitivenessCommittee/SeconedRound_ProfGilson.pdf. See also Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, 43 INT’L REV. L. & ECON. 119 (2015).

³² Edward B. Rock, *MOM’s Approval in a World of Activist Shareholders* (this volume). Rock further questions the significance of the difference between an MoM-based approval and an Entire Fairness review in light of the fact that when the breaching transaction cannot be unwound, the court will award damages that will be calculated with reference to market benchmarks. Granted, complex transactions often cannot be undone such that voidability could be ineffectual. This observation does not imply a reference to market benchmarks for assessing rescissory damages, however. The appropriate remedy against a breaching fiduciary is accounting in equity, which is not limited to rescission or contractual damages. This point is re-emerging in Delaware jurisprudence. See *Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1252 (Del. 2012).

³³ Goshen and Hamdani, *supra* note 17, at 610-611. The authors’ analysis follows Goshen, *supra* note 17, at 409.

test” for reviewing self-interested transactions.³⁴ Regardless of such expertise, which scholars still debate,³⁵ no court can neutralize the fiduciary’s informational superiority that stems from non-observable and non-verifiable information.³⁶ As a normative matter, I am therefore firmly on the side of those who insist on ensuring the beneficiary’s fully-informed consent - a property-rule-like regime. A fiduciary does not take; a fiduciary asks. The property-rule/liability-rule framework, imprecise as it may be, 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 license to expropriate with impunity. Seen this way, it requires little to realize that such a regime is inefficient in terms of resource allocation and market viability.³⁷

Bearing in mind that a full analysis of the normative question is beyond the present scope, some readers might nonetheless remain unpersuaded that a substantive fairness review of fiduciary self-dealing is inefficient. Proponents of the Entire Fairness regime may still find interest in the present analysis, if not about the *law* of fiduciary self-dealing then about the *lawyering* of this subject in Israel, which could bear some general lessons. In tandem, when this facet is acknowledged, the legal question exceeds the issue of efficiency and becomes one of values and politics -

³⁴ See Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437, 455 (1993); E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 *DEL. J. CORP. L.* 503, 512 (1986).

³⁵ See, recently, Erasmo Giambona, Florencio Lopez de Silanes, & Rafael Matta, *Stiffing the Creditor: The Effect of Asset Verifiability on Bankruptcy*, working paper (2017).

³⁶ See Amir N. Licht, *Motivation, Information, Negotiation: Why Fiduciary Accountability Cannot be Negotiable*, in *RESEARCH HANDBOOK ON FIDUCIARY LAW* (Andrew Gold & D. Gordon Smith, eds., forthcoming).

³⁷ Very briefly, fiduciary expropriation impairs efficient resource allocation as it ignored the beneficiary’s preferences; it could threaten market viability due to a “market for lemons” effect. See George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 *Q.J. ECON.* 488 (1970).

namely, whether powerful parties deserve the privilege of expropriating value from parties who are put at their mercy, even if by the latter's own volition (e.g., as public shareholders).³⁸ Seen this way, as a values-based issue, no amount of persuasion might suffice.

2.3. The Entire Fairness Puzzle

From a positive-comparative perspective, jurisdictions differ in their regulation of public company RPT approval. In the United Kingdom, listing rules implement an MoM mechanism in public companies.³⁹ In contrast, engaging in a corporate RPT in Delaware famously can escape liability if it passes an entire fairness review, described as “Delaware’s most onerous standard”.⁴⁰ In certain circumstances of potential conflict, liability may be avoided subject to a more lenient enhanced scrutiny review.⁴¹ In tandem, recent case law has carved out spheres, in which Entire Fairness analysis is inapplicable - when fully-informed and disinterested decision makers approve a tainted transaction, including by an MoM approval if a controlling shareholder is involved - namely, a property-rule regime.⁴² In Canada, due to idiosyncratic historical circumstances, a substantive fairness review may follow any

³⁸ Gilson and Schwartz, *supra* note 31 at 122, indeed acknowledge this point, yet argue that some level of unilateral taking could be maintained for other reasons.

³⁹ See FINANCIAL CONDUCT AUTHORITY, LISTING RULES (2017), LR 11.1 Related Party Transactions, <https://www.handbook.fca.org.uk/handbook/LR/11/1.html>.

⁴⁰ See Delaware General Corporation Law § 144; *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013); see also *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, 2016 Del. Ch. LEXIS 14.

⁴¹ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Trados, ibid.*; see also J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV. 1443 (2014).

⁴² See *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014); *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015); *In re Martha Stewart Living Omnimedia, Inc. Shareholders Litigation*, 2017 Del. Ch. LEXIS 151 (Del. Ch., 2017).

form of approval.⁴³ This chapter will focus on the first two doctrinal approaches, which are the ones that have influenced Israeli law.

English law's stance is straightforward and has been stable for a long time in upholding a property-rule regime in companies as in other fiduciary relations. The 1854 decision in *Aberdeen Railway* remains good law:

A corporate body can only act by agents, and it is, of course, the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such an agent has duties to discharge of a fiduciary character towards his principal, and it is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.⁴⁴

The development of Delaware's law has been more convoluted. Marsh pointed out long ago that U.S. states during the nineteenth century had followed *Aberdeen Railway* and endorsed its reasoning, but then a gradual deterioration process ensued, at the end of which courts in several states accepted that substantive fairness of the self-dealing transaction can trump its voidability.⁴⁵ Marsh did not mince words in describing this development, referring to decisions that strayed from traditional

⁴³ See Lionel Smith, *North-West Transportation Co. Ltd. v. Beatty* (1887), in LANDMARK CASES IN EQUITY 393 (Charles Mitchell & Paul Mitchell, eds. 2012), analyzing *North-West Transportation Co Ltd v. Beatty*, (1887) 12 AC 589 (P.C.).

⁴⁴ *Aberdeen Railway Co. v. Blaikie Brothers* [1854] UKHL 1, (1854) 1 Macq 461, 471-472 (H.L.), following *Keech v. Sandford* [1726] EWHC Ch J76, (1726) 25 E.R. 223; Ex parte *James* (1803) 32 ER 385. For current expositions see PAUL L. DAVIES & SARAH WORTHINGTON, *GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW* 561 (9th ed., 2012); GRAHAM VIRGO, *THE PRINCIPLES OF EQUITY AND TRUSTS* 497 (2012). In assessing the importance of *Aberdeen Railway* today, one may distinguish between practice and principle. As a matter of practice, outside the sphere of listed companies a company's approval of a tainted transaction has to comply with the mechanism prescribed in its bylaws, which could simply be the board (*sans* the tainted director). As a matter of principle, however, *Aberdeen Railway* remains a leading precedent for the irrelevance of [un-]fairness to breach of loyalty, and courts rely on it for interpreting statutory duties of directors under the Companies Act, 2006 (U.K.). See, e.g., *Towers v. Premier Waste Management Ltd* [2011] EWCA Civ 923, [8] (Mummery LJ).

⁴⁵ See Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966); see also Norwood P. Beveridge, *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655 (1992); Norwood P. Beveridge, *Interested Director Contracts at Common Law: Validation under the Doctrine of Constructive Fraud*, 33 LOY. L.A. L. REV. 97 (1999).

doctrine as “shamefaced”, as it granted corporate insiders power to benefit themselves.⁴⁶ A broad consensus among prominent American scholars concurs with Marsh,⁴⁷ some of whom use equally strong words to deplore the Entire Fairness doctrine.⁴⁸ The Delaware Chancery and some of its judges writing extra-judicially have acknowledged this problem, too.⁴⁹ Yet according to Clark, the reasons for this legal transformation have remained a historical puzzle.⁵⁰ This situation is all the more puzzling because in non-corporate fiduciary contexts, Delaware adheres to the traditional “no further inquiry” approach to fiduciary self-dealing.⁵¹

A novel analysis of this development was advanced more recently by David Kershaw, based on a thorough doctrinal review of the jurisprudence of New York and New Jersey, the legal leaders during the nineteenth century, to which Delaware joined only later without much discussion.⁵² Kershaw relates the departure of U.S. law on corporate self-dealing from the U.K. position to differences in the conception of the corporation between the two legal systems. Against this backdrop, courts committed a series of doctrinal missteps that in due course gave rise to Entire Fairness. Referring to New York jurisprudence, Kershaw says:

A persuasive explanation is not available. But one cannot disregard an explanation that discounts politics, pressure groups and rational responses of

⁴⁶ Marsh, *ibid.*, at 41.

⁴⁷ See, e.g., CLARK, *supra* note 17, at 160-166; Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 997 (1988); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law* 38 B.C.L. REV. 595, 613 (1997); James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1078-1080 (2003); Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 668 (2002); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 334 (2004).

⁴⁸ See Cox, *ibid.*, at 1078.

⁴⁹ See *Solomon v. Armstrong*, 747 A.2d 1098, 1115 (1999); Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 667 (2010).

⁵⁰ CLARK, *supra* note 17, at 166.

⁵¹ See *Oberly v. Kirby*, 592 A.2d 445 (Del. 1991); *Stegemeier v. Magness*, 728 A.2d 557 (Del. 1999).

⁵² See David Kershaw, *The Path of Corporate Fiduciary Law*, 8 NYU J. L. & BUS. 395 (2012).

lawmakers to those pressures and views legal change as the result of a fair pinch of incompetence in reading the cases and applying the common law method.⁵³

While Kershaw's analysis shows that the dominant factors that supported the development of this doctrine may have been legally principled, one cannot dismiss the implication that the fact that it effectively caters to insiders and its very development may well be regarded as a legal accident.

3. REGRESSION ANALYSIS: ISRAELI LAW OF CORPORATE RPTs

3.1. Israeli Company Law and Corporate Governance: A primer

Israeli law has common law origins thanks to the heritage of the British rule and Mandate in Palestine, which were in force from 1917 to 1948, when the State of Israel was established. Applicable law thus consists of an amalgam of statutes and case law. To date, there are still a considerable number of statutes in force enacted during the British Mandate ("Ordinances") that were re-enacted, amended, or replaced by acts of the Israeli parliament, the Knesset ("Laws"). Thus, the Israeli Companies Law, 1999 replaced and supplemented much of the Companies Ordinance, 1929, which closely followed the U.K. Companies Act, 1929. In addition to the Companies Law, Israeli corporate governance law comprises the Securities Law, 1968, dealing with securities regulation, and the remaining parts of the Companies Ordinance, 1929, that currently regulate corporate bankruptcy. A host of specific statutes that regulate institutional investors and other financial institutions bear on corporate governance issues as well.

Israel's designation as a common law system has been subject to significant scholarly debates. Some authors have argued that Israel is a mixed jurisdiction, not

⁵³ Kershaw, *ibid.*, at 479.

unlike Scotland, South Africa, and Louisiana, pointing to a codification project carried out mainly during the 1960s and early 1970s that was supposed to introduce a civil code in the Civil Law tradition.⁵⁴ Such claims are greatly overstated, however. While that legislative reform did clarify and modernize certain areas of private law, it hardly affected Israeli fiduciary law and did not affect the structure of the legal system. Adjudication, in a British-Mandate-designed court system, has been and remains in the common law tradition in all of its manifestations.⁵⁵ The Israeli Supreme Court repeatedly, and proudly, refers to the “common law Made in Israel”. References to Civil Law sources in its jurisprudence have never exceeded a negligible level compared to citations of common law authorities, which is not surprising as the former are virtually inaccessible to Israeli lawyers due to language barriers.⁵⁶

According to a 2012 OECD report, about 75% of listed companies in the Tel Aviv Stock Exchange were controlled by family or individual interests.⁵⁷ Twenty business groups (nearly all of them family-owned) controlled 160 publicly-traded companies with a 40% segment of the market by market capitalization. The market segment of the ten largest groups was estimated at 30%. A major structural reform took place in 2013 in the wake of social protests during 2011. A committee found that these pyramidal groups, among the tallest in the world in terms of layers of holdings, are characterized by widespread presence in various sectors, a large number of inter-market encounters, an extensive network of inter-group connections that is

⁵⁴ For discussion and references *see*, recently, Eliezer Rivlin, *Israel as a Mixed Jurisdiction*, 57 MCGILL L.J. 781 (2012); Nir Kedar, *Law, Culture and Civil Codification in a Mixed Legal System*, 22 CANADIAN J. L. & SOCIETY 177 (2007).

⁵⁵ Section 20 of the Basic Law: Adjudication (Isr.).

⁵⁶ *See* Yoram Shachar, *The Reference Space of the Supreme Court, 1950-2004*, 50 HAPRAKLIT 29 (2009) (Hebrew).

⁵⁷ OECD, *supra* note 14, at 94-95.

reflected in ownership ties, and a network of common directors, as well as a high level of leveraging. In short, “a few individuals or families control large, complex and leveraged structures, and do so mainly by means of other people’s money.”⁵⁸ Having mustered the political will to implement the committee’s recommendations, the Israeli government passed legislation that prohibits the creation of pyramidal structures of listed companies having more than two layers and prescribes the dismantling of extant pyramids exceeding two layers through consolidation of layers, sale of public subsidiaries, or in any other way.⁵⁹ A number of controlling shareholders in those groups have since become bankrupt, leading to changes in controllers’ identity but not to significant changes in control structures. Dismantling of pyramids is still underway.

3.2. From London to Jerusalem

Israel’s fiduciary law was cast in the English mold in the early days of the new state, continuing the legal tradition from the Mandate period. In the case of *Aghion* the Supreme Court phrased managers’ duty of loyalty in canonical terms:

Company managers serve as its agents and mandataries. To some degree they are its trustees, and as managers they must direct their actions for its benefit, and only for its benefit. Any other interest, personal, peripheral, must not affect them and distract their heart from the company and its benefit. ... where a company manager, out of scheming and betrayal, promises and undertakes to act in a manner that may clearly conflict with the company, his promise is no promise and his undertaking is no undertaking.⁶⁰

The seminal case in Israeli law with regard to fiduciary self-dealing is *Tokatli v. Shimshon Ltd.*, which involved a contract between a company and a board member,

⁵⁸ THE COMMITTEE ON INCREASING COMPETITIVENESS IN THE ECONOMY, FINAL RECOMMENDATIONS AND SUPPLEMENT TO THE INTERIM REPORT 12 (2012), http://www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/publications/Final_Recommendations.doc.

⁵⁹ Increasing Competitiveness and Decreasing Concentration Law, 2013.

⁶⁰ Mo. 100/52 *Hevra Yerushalmit LeTaasiya Ltd v. Aghion*, 6 P.D. 887, 889 (1952), citing *Cook v. Deeks*, [1916] 1 AC 554, [1916] UKPC 10. All translations are mine.

who was also an insurance agent, for the sale of insurance to the company at market rates.⁶¹ Applying *Aberdeen Railway*, Justice Landau held:

Even if giving the insurance to the Appellant could not have caused any actual harm to the Respondent, one cannot see a justification to making this contract, because “it is a universal rule that no trustee is allowed to make agreements, in which he has or may have a private interest that conflicts, or possibly may conflict, with the interest of those whom it is his duty as a trustee to protect. So absolute is the insistence on this principle, that one is not allowed to raise the question, if the transaction is fair or unfair.” *Aberdeen Railway Co. v. Blakie Brothers* (1854)...⁶²

Tokatli was cited with agreement in several cases, most notably *Kossoy v. Y.L. Feuchtwanger Bank Ltd.*, possibly the most important corporate law and fiduciary law decision in Israeli law.⁶³ The principle that actual and potential conflicts are treated equally strictly was applied to other fiduciaries, including agents and guardians.⁶⁴ In another seminal case, *Hasson v. Local Council Daliat ElCarmel*, which confirmed civil servants’ status as fiduciaries, Vice-President Agranat specifically referred to *Aberdeen Railway* among other English authorities.⁶⁵ During the latter part of the twentieth century it became clear that the attempts to uproot the common law from Israel’s private law have failed. In tandem, the Supreme Court emphasized that Israeli law, while adhering to its common law origins, may also draw inspiration from American sources. For example, in *Kossoy* this idea was reflected in recognizing a

⁶¹ C.A. 267/55 *Tokatli v. Shimshon Ltd.*, 11(2) P.D. 1569 (1957).

⁶² *Ibid.*, at 1579. Since Hebrew does not have a special word for “fiduciary”, Landau J uses “trustee” (נאמן) as the closest term available. Recently, I proposed אמונאי and אמונאות as a translation for the person and the relationship, respectively.

⁶³ C.A. 817/79, *Kossoy v. Y.L. Feuchtwanger Bank Ltd.*, 38(3) P.D. 253 (1984).

⁶⁴ See, respectively, C.A. 2664/90 *Perlov v. Nassimi*, 48(1) P.D. 787 (1994); C.A. 4377/04, *Goren-Holtzberg v. Miraz*, 62(2) P.D. 661 (2007).

⁶⁵ C.A. 254/64 *Hasson v. Local Council Daliat ElCarmel*, 19(1) P.D. 17 (1965); see also H.C.J. 531/79 *Siat HaLikud in Petah Tikvah Municipality v. Mayor of Petah Tikvah*, 34(2) P.D. 571 (1980).

controlling shareholder's duty of loyalty to the company upon sale of control to a looter - a duty stated to be identical to a manager's duty of loyalty.⁶⁶

3.3. From Wilmington to Tel Aviv

The rise of American influence on Israeli company law may be attributed primarily to the enactment of the new Companies Law in 1999. Prior to that move, Israel in 1981 legislated the English rule on unfair prejudice in lieu of the oppression of the minority doctrine, and in 1991 it legislated the duties of care and loyalty of corporate officers (i.e., directors and top executives), thus consolidating prior case law, and allowed limited contracting around those duties. A 1988 amendment imposed on listed companies a duty to nominate at least two independent directors and to establish audit committees.

The 1999 Law came in the wake of a long preparatory work conducted by Uriel Procaccia and a committee headed by Aharon Barak (starting it as a professor and ending as the President of the Supreme Court). Procaccia's report was heavily influenced by mid-1980s views in the law and economics literature and by American corporate law.⁶⁷ The final version of the statute provided a more realistic rendition of these ideas, reflecting adjustments to a corporate governance environment dominated by controlling shareholders and inevitable political compromises. To the provisions on office holders' duties of care and loyalty, which remained unchanged, the Law added a novel provision imposing a "duty of fairness" on controlling shareholders as well as other shareholders with power to nominate directors, to affect the vote in the general meeting, and other powers. The precise nature of this duty has been subject to

⁶⁶ See Kossoy, *supra* note 63, citing *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955); D.N. 29/84 *Kossoy v. Y.L. Feuchtwanger Bank Ltd.*, 38(4) P.D. 505 (1984). On Anglo-American basis for remedies for breach of loyalty see C.A. 84/80 *Kassem v. Kassem*, 37(3) P.D. 60 (1983).

⁶⁷ See Uriel Procaccia, *Designing a New Corporate Code for Israel*, 35 AM. J. COMP. L. 581 (1987); Uriel Procaccia, *Crafting a Corporate Code from Scratch*, 17 CARDOZO L. REV. 629 (1996).

extensive debates, a predominant view in judicial dicta and among commentators being that it is a “weakened duty of loyalty”.⁶⁸ The remedies mentioned in the Law with regard to breach by office holders and controlling shareholders of their duties of loyalty or fairness, respectively, are nonetheless phrased in similar terms.⁶⁹

Beyond the general reassertion of the duties of company office holders, the Law introduced a specific regime for RPTs.⁷⁰ Transactions of an office holder and certain transactions of a controlling shareholder with the company and transactions in which they have an interest are subject to approval according to the type of transactions and the circumstances. The key feature in these mechanisms is that disinterested corporate organs are authorized to approve such transactions on the basis of full disclosure from the interested party. A transaction in which a controlling shareholder of a listed company has an interest requires a “triple approval” - by the audit committee, the board, and (since 2011) a majority of disinterested shareholders.⁷¹ Transactions not duly approved are void *inter se* and toward a third party who knew or had to know about the lack of approval.

The general layout of this regime is compatible with the most advanced arrangement around the world, as noted above. When stripped from its technical details, this regime constitutes an elaboration of the traditional principle that tainted fiduciary action can be validated only by the beneficiary’s fully-informed consent -

⁶⁸ See, recently, *Vrednikov Appeal*, *supra* note 16 (reviewing sources); see also C.A. 345/03 *Reichart v. Yorshei HaManuach Ezra Shemesh Z”L* 62(2) P.D. 437 (2007). To my opinion, this duty, notwithstanding its unfortunate name, is a regular duty of loyalty, though one that applies only in certain circumstances. See AMIR N. LICHT, *DINEY EMUNAUT* 100-121 (2013) (Hebrew; “Fiduciray Law”).

⁶⁹ See Companies Law, sections 256, 193, 283.

⁷⁰ Companies Law, sections 270-283.

⁷¹ The Law does not explicitly require an approval by disinterested directors. An approval by the audit committee, which must have a majority of independent directors, may be a reasonable approximation. Subsequent case law imposed such a requirement, however.

namely, a property rule - while lack of authorization renders the breach voidable at the election of the beneficiary and the fiduciary - liable to account.⁷² What the Law does not do is to say that company insiders can get away with an RPT if its terms are economically appropriate. Nor does case law, in light of *Tokatli* and its progeny, suggest this. Israeli courts have reached this conclusion nonetheless.

The most fateful development toward the transformation of Israeli law on corporate RPTs was the establishment of the Economic Division in the Tel Aviv District Court, widely known as “the economic court”. Among the factors that supported this move was Delaware’s image as the promised land of corporate law, which has been common in Israel as it is in other countries, as was the image of its chancery and supreme courts as world leaders. Since the late 1990s, moreover, Israeli entrepreneurs, encouraged by Israeli law firms, have incorporated start-up firms in Delaware with a view to listing them on U.S. stock markets, thus adding to familiarity with Delaware law.⁷³ In 2004, the Israeli Securities Authority nominated a committee headed by Zohar Goshen to examine the adoption of a corporate governance code. Having expanded its review to additional issues, the Goshen Committee in 2006 recommended to establish a specialized court for corporate and securities law according to the Delaware model and to require a majority of disinterested shareholders in a general meeting approval of controlling shareholders’ RPTs.⁷⁴ The

⁷² For present purposes I put to one side the rule that an unauthorized action by an agent is a nullity, which is also mentioned in the Law.

⁷³ See Amir N. Licht, *David’s Dilemma: A Case Study of Securities Regulation in a Small Open Market*, 3 THEORETICAL INQUIRIES L. 673 (2001); Edward B. Rock, *Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Markets*, 2 THEORETICAL INQUIRIES L. 711 (2001).

⁷⁴ See Israel Securities Authority, ISA Adopts Final Version of the Goshen Report, December 17, 2006, <http://www.isa.gov.il/sites/ISAEng/1489/1511/Pages/1737.aspx>. At the time, the Companies Law required only a “sub-majority” of one third of the disinterested shareholders - an odd outcome of a compromise with business interests’ demands during the drafting of the Law.

committee recommended that once such a court is established, public companies would be able to approve related party transactions with a simple majority (namely, without the qualification of a majority of disinterested shareholders), in which case the controlling shareholder and the company managers will bear the burden of proof, in court, with regard to the fairness of the transaction.

Legislative amendments adopted the first two recommendations separately but rejected the third as well as the linkage that the committee tried to make to the idea of fairness review. A 2011 amendment to the Companies Law implemented the MoM threshold. A few months earlier, in 2010, the Economic Division was established following calls from business circles and government committees. The atmosphere was festive. “From Delaware to Israel” wrote commentators,⁷⁵ and the image of the Economic Division as a local rendition of Delaware’s Chancery Court has stuck until current time.⁷⁶ In a meticulous investigation of Israeli business case law since the court’s establishment, Yifat Aran finds that the scope of business litigation has increased, yielding many new rulings, while most of the additional cases have been handled by the court’s judges who tend to refer to their own decisions.⁷⁷ By technical parameters of case management, such as length of time for handling cases, the Economic Division does not differ from other district courts although its cases could be more complex. General satisfaction with the Tel Aviv Economic Division led the Minister of Justice in mid-2017 to announce plans to establish a similar division in Haifa, in northern Israel.

⁷⁵ See Daniel Rimon & Tal Amir, *Beit Mishpat Calcali - MiDelaware LeIsrael*, 7(4) TA’AGIDIM 3 (2010) (translation: “An Economic Court - From Delaware to Israel”).

⁷⁶ See, e.g., Yasmin Gueta & Efrat Neumam, *Haftaa BeVeit HaMishpat HaCalcali*, THEMARKER, March 23, 2017.

⁷⁷ See Yifat Aran, *The Effects of Specialization: Empirical Evidence from an Economic Court*, working paper (2016), <https://ssrn.com/abstract=2802353>.

Assessing whether the Tel Aviv Economic Division succeeded in dealing with corporate RPTs requires more than a count of cases and days. It calls for delving into legal substance. Although entire fairness review was mentioned before the court was established,⁷⁸ it was the court's first significant decision in *Kahana v. Makhteshim Agan Industries Ltd.* which truly ushered this doctrine into Israeli jurisprudence.⁷⁹ A challenge to a complex sale of control transaction was brought by a minority shareholder as a claim for unfair prejudice. In holding that the controlling shareholder is not entitled to excess consideration, the court invoked Delaware's Entire Fairness doctrine to point out that the process was badly tainted by conflict of interest and that the consideration was divided unequally between the controller and public shareholders. Handed down at a time of social protest, *Kahana* is widely considered as the Economic Division's most important decision, as it positioned the new court as a defender of public shareholders against abusive controllers. This holding was later cited with agreement in brief dicta by the Supreme Court.⁸⁰ In the following years, the court issued several decisions that referred to the fair price prong of Delaware's Entire Fairness - namely, the rule that fair price trumps a breach of loyalty - as reflecting positive or desirable Israeli law. The following excerpt represents this approach:

When a decision is taken where the decision maker is found in a conflict of interests, the decision is "suspect" in terms of its content in light of the fact that the decision maker seemingly breaches his duties of loyalty, and because he may be personally enriched by the decision. Thus, there is justification to imposing an increased burden on the party requesting to approve a decision like that - such that he

⁷⁸ See Bkc'y (T.A.) *Eshkoli v. Berkovitz* (8.6.2004).

⁷⁹ See Cl.Ac. 26809-01-11 *Kahana v. Makhteshim Agan Industries Ltd.* (15.5.2011).

⁸⁰ See C.A. 2718/09 *Gadish Provident Funds Ltd. v. Elscint Ltd.* (28.5.2012); C.A. 3136/14 *Cabiri-Shamia v. I.D.B. Hevra LeFituakh Ltd.* (28.1.2016).

will prove that despite the conflict of interests in which he was found, the decision is entirely fair to the company.⁸¹

Stated in the analytical framework used here, the *Financitech* court views corporate fiduciaries' duty of loyalty in a self-dealing situation as a liability rule. In this view, a conflicted fiduciary may escape liability if she can show that the tainted action was, substantively, entirely fair to the company. Such a view is in line with Delaware law.⁸² However, the above proposition and several others like it contradict applicable Israeli law in light of Supreme Court precedents, and are at least questionable in light of statutory provisions. This point apparently was lost on the parties involved. To my knowledge, neither *Tokatli* nor relevant sections of the Companies Law have been cited or discussed in extant cases with regard to tainted RPTs or other fiduciary actions.⁸³ What one usually finds as justification for such positions are references to Delawarean entire fairness as *ipso facto* the law in Israel - an unfounded proposition, with respect, at least thus far.

The expectations - including, perhaps, self-expectations - that the Economic Division's budding jurisprudence will follow Delaware's have also been manifested outside its written opinions. A series of conferences co-organized by the Ono Academic College and Columbia Law School brought together judges from the Economic Division, chancellors and justices from Delaware, corporate law practitioners, and academics from both countries. These conferences provided regular opportunities for the judges to exchange views, present legal developments during each passing year before the distinguished audience, and make comparisons between

⁸¹ Der.A. (T.A.) 13663-03-14 *Neuman v. Financitech Ltd.* (24.5.2015), at [60].

⁸² See *Weinberger*, *supra* note 40; *Trados*, *supra* note 40.

⁸³ In one recent case, Section 280, providing for nullity of unauthorized controller's RPTs, was cited by the movant-plaintiff but not discussed by Kaboub J. See Der.A. (T.A.) 628-08-14 *Krauskopf v. HaHevra LeIsrael Ltd.* (26.6.2016).

the two jurisdictions. In such a social atmosphere, the not-always-implicit anticipation that the two should converge could not have reasonably been ignored.

This transformation process reached its high watermark in the Supreme Court's decision in the *Vrednikov* appeal, where a shareholder in a public utility company argued that board members breached their duties by increasing its leverage through dividend payouts, raising debt capital, and capital reductions, while the controlling shareholder needed cash to service his LBO-related debts. The trial court found that there was a real possibility that the controller had substantial influence on the board's decision-making process. In the Supreme Court, Amit J noted that "in the corporate law in Delaware there have developed three different standards of review for corporate business decisions."⁸⁴ He was reluctant to adopt the Entire Fairness doctrine, yet left the door open for it in the future.⁸⁵ Instead, the Court focused on an "enhanced scrutiny" approach, as it held that the circumstances created a potential conflict for the controlling shareholder and the board:

This standard is meant to deal with circumstances in which applying the business judgment rule might "miss" a breach of duties of loyalty by the office holders, particularly in the presence of a potential conflict of interest stemming from the dynamics of the decision making. Within the intermediate standard as it has developed in Delaware (where the standard was created for cases in which the board acts to thwart a hostile takeover), the initial burden lies on the directors, who are required to show that their decision was reasonable.⁸⁶

In light of this holding the Court examined in detail the business logic of several strategic financial decisions made by the board and eventually found them reasonable, such that no liability was imposed on the directors.⁸⁷

⁸⁴ *Vrednikov Appeal*, *supra* note 16, at [67] (Amit J).

⁸⁵ *Ibid.*, at [87].

⁸⁶ *Ibid.*, at [103].

⁸⁷ Since the Supreme Court treated the circumstances as evincing potential conflict for the directors, the present analysis proceeds on the same assumption. Note, however, that *Verdnikov* did not involve conventional self-dealing as board members did not derive a pecuniary benefit from exercising

The Court's move is, with respect, legally unfounded and normatively unsound. The notion of "careful scrutiny" had been noted in dicta beforehand,⁸⁸ and the Economic Division treated Delaware's enhanced scrutiny standard alternatively as part of Israeli law or as desirable law.⁸⁹ In Israeli fiduciary law, however, as in most other common law jurisdictions,⁹⁰ it is trite law that potential conflict is a conflict for all intents and purposes. According to the Economic Division and the Supreme Court, however, this is no longer "a rule of universal application", as *Aberdeen Railway* and *Tokatli* insist. The only justification mentioned for making this ruling, beside noting earlier Economic Division rulings in other settings, is that Delaware recognizes different standards of review.⁹¹ The upshot is that potentially conflicted transactions could be upheld *post hoc* if they met a reasonableness threshold.⁹²

The most striking consequence of this development is that Israeli law post-*Vrednikov* has outflanked American law in tolerating RPTs. Not only would Israel's property rule on corporate RPTs be discarded in cases of potential conflict, the *Vrednikov* appeal, read on its terms, only required that the tainted action is shown to

fiduciary powers. It could more appropriately be regarded as a case of bad faith exercise of power or taking foreign considerations into account in exercising fiduciary powers. Moreover, it is submitted that the circumstances, especially of the dividend payouts, did not support a finding of potential conflict to begin with, such that the non-liability result can be justified on other grounds.

⁸⁸ See C.A. 2773/04 *N.Z.B.E. Hevra LeHitnakhlat Ltd. v. Atar*, 62(1) P.D. 456 (2006) (Barak PR, minority opinion).

⁸⁹ See, e.g., Cl.A. 47490-09-13 *To'elet LaZibur v. Clal Ta'asiot Ltd.* (6.8.2015); Cl.A. 37908-11-12 *Prilok v. Kol Hakhzaka Ltd.* (8.12.2015).

⁹⁰ To be sure, this includes Delaware, where an "unacceptable risk of bias" suffices to disable directors. In re *Oracle Corp Derivative Litigation*, 824 A.2d 917, 947 (Del. Ch. 2003) ("[T]hese connections generate a reasonable doubt about the SLC's impartiality because they suggest that material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments.")

⁹¹ *Vrednikov Appeal*, *supra* note 16, at [89].

⁹² Proponents of substantive entire fairness review could argue that differences between this regime and a fully-informed-consent regime become notional when the tainted transaction cannot be undone, as is often the case in major deals involving structural changes. Under both regimes, runs the argument, the court ends up assessing damages based on fair market values. This view is misguided. While rescission of a tainted transaction might not be a viable option at times, the appropriate remedy in such cases is account, which may include but is not limited to market-value-based damages.

be reasonable. It does not even have to look entirely fair.⁹³ Moreover, both courts have voiced willingness to review fully-approved RPTs for their reasonableness in undefined special circumstances⁹⁴ - a proposition that undermines the property-rule regime and is inconsistent with current developments in Delaware case law.⁹⁵

The corrosive process that the *Vrednikov* appeal epitomizes receded somewhat thanks to a short decision by Supreme Court President Naor dismissing a petition to hold a further hearing of the *Vrednikov* appeal in an enlarged panel. In it, she drastically narrowed the holding of the appeal to “the unique case of a changing a company’s capital structure shortly after a leveraged purchase”, while noting that the ruling does not affect other breaches of officer duties such that their reasonableness, as part of an enhanced scrutiny, should not be examined.⁹⁶ The latter statement may go beyond the language of the decision in the appeal but is laudable nonetheless, as it redirects Israeli law to the right legal course. At the same time, the ruling in the appeal has not been vacated and the dicta dealing with entire fairness have not been discussed. It remains to be seen how and to what extent the Economic Division will implement the spirit of the further hearing decision.

4. CONCLUSION

To a non-Israeli lawyer seeking to understand and design optimal regulation for corporate RPTs, the Israeli experience is puzzling. Why would a legal system abandon a core principle that has been historically stable and a mechanism that is

⁹³ Delaware law recognizes that in crisis situations, a controlling shareholder’s unique and desperate need for liquidity could create a disabling conflict of interest, but then an entire fairness review is called for rather than enhanced scrutiny. *See New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 Del. Ch. LEXIS 147, *2-3 (Del. Ch. 2011); *In re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022, 1036 (Del. Ch. 2012).

⁹⁴ *See To’elet LaZibur*, *supra* note 89, at [32]; *Vrednikov Appeal*, *supra* note 16, at [32].

⁹⁵ *See M&F Worldwide*, *supra* note 42; *Corwin*, *supra* note 42.

⁹⁶ Civil Further Hearing 1380/17 *Vrednikov v. Elovitch* (30.8.2017), [20]-[21] (Isr.).

widely agreed to be superior (including by Delaware courts⁹⁷)? Why would a specialized business court seek to adopt a regime that prominent commentators agree is deplorable without even discussing this question? Why would this court ignore case- and statutory law that is binding on it and why wouldn't its supreme court intervene to rectify this error? Even observers who do not consider liability-rule regulation of RPTs to be inferior - namely, the law on the matter - might still be alarmed by the institutional failures that the Israeli episode demonstrates - i.e., the lawyering.

The unfolding of the events suggests that history might be repeating itself - namely, that a plausible reason for it is a legal accident like the one that occurred in U.S. law in the nineteenth century, which Marsh identified and Kershaw analyzed. While certain individuals and interest groups could benefit from this erosion in RPT regulation, the cases provide no hint that the courts heeded to such interests. To the contrary, the courts' stated motivation is to buttress the protection of companies and public shareholders from powerful insiders. To this end, they have looked uncritically to the Delaware appellation while ignoring important Israeli and other comparative jurisprudence and providing no justification for this move. That the result was quite the opposite is thus ironic: the establishment of a specialized corporate and securities court has engendered a converse effect than the corporate governance improvement anticipated from it.

Several countries have implemented corporate governance reforms by transplanting fiduciary duties originating from American sources. Others have established specialized courts with a view to mimicking Delaware's chancery. In assessing such reforms commentators often focus on powerful forces that could

⁹⁷ See *M&F Worldwide*, *supra* note 42, at 643.

thwart them such as wealthy families that have a grip over the economy and politics or countries' cultural and social institutional infrastructure.⁹⁸ This paper adds to the literature the modest insight that sometimes, weak forces, too, can exert a significant effect. The Israeli experience provides a sobering reminder that such initiatives should be implemented with keen attention to the legal infrastructure in which such a court is to operate, and surely without any naïve expectations.

⁹⁸ See, e.g., Hideki Kanda & Curtis J. Milhaupt, *Re-Examining Legal Transplant: The Directors Fiduciary Duty in Japan Corporate Law*, 51 AM. J. COMP. L. 887 (2003); Lynn A. Stout, *On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can a Transplant Take?*, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNMENT IN A NEW ERA OF CROSS-BORDER DEALS 46 (Curtis J. Milhaupt ed., 2003); Amir N. Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L LAW. 195 (2004); Lilian Miles, *The Application of Anglo American Corporate Practices in Societies Influenced by Confucian Values*, 111 BUS. & SOC'Y REV. 305 (2006); Jingchen Zhao, *Promoting a More Efficient Corporate Governance Model in Emerging Markets Through Corporate Law*, 15 WASH. U. GLOBAL STUD. L. REV. 447 (2016).

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