

SHAREHOLDER (AND DIRECTOR) FIDUCIARY DUTIES AND SHAREHOLDER ACTIVISM

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I. INTRODUCTION

A quiet corner of corporate law academia continues to debate the trend (if it is a trend and not a sudden lumpy apparition) toward imposing fiduciary duties on controlling shareholders.¹ I have tried elsewhere² to counter the arguments in favor of imposing fiduciary duties on controlling shareholders, and I will not repeat those arguments here. The crux of my argument is that fiduciary duties are owed by those who have power, in the legal sense, over other people's persons or property. In the corporate context, the individuals with power are directors. Shareholders may have indirect power or influence, but they have no *legal* power over corporate property, and certainly no *legal* power over other shareholders' property. They have power only over their own property (their shares) – a fact the law recognizes by zealously protecting the shareholder's right to vote³ and to sell his or her shares.⁴

Developments since the turn-of-the-millennium financial scandals (commonly referred to as “Enron”) have both confirmed my earlier arguments and raised new issues. For one thing, the scandals have revealed that it is not only minority shareholders in closely held corporations who are subject to exploitation and oppression. More interestingly, since Enron, we have seen an increase in “shareholder activism.” Some of this activism – efforts to improve governance in public companies or to rein in executive pay – may be a fairly direct response to the excesses that the Enron era exposed.⁵ Another form of activism, often engaged in by hedge funds, involves attempts directly to affect, and often to control, management decisions.⁶ This latter kind of activism seems related to the Enron phenomenon only

1. See, e.g., Douglas K. Moll, *Minority Oppression and the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883 (2005); F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL & THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS §§ 7:3-7:6 (2d ed. 2005); Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 699 (1993).

2. See Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 HOFSTRA L. REV. 175, 176 (2004).

3. See, e.g., *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659-60 n.2 (Del. Ch. 1988).

4. See *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 762 (Del. Ch. 2006); *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387, 388 (N.Y. 1979).

5. See, e.g., Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005); Imam Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 568-69 (2006).

6. See Robert S. Karmel, *Should a Duty to the Corporation be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 1 (2004).

chronologically, although it perhaps is a response to related changes in the market. Both kinds of activism raise questions about fiduciary duties in public corporations that have yet to be addressed.⁷

Most of the discussion of shareholder activism has been informed by practical economic and financial considerations rather than legal ones. This article explores the relevant law and applies it to recent developments in shareholder behavior. To that end, in Part II, I begin with a brief review of fiduciary law. In Part III, I review the legal relationship between the shareholders and the boards of directors, which is ordinarily a contractual relationship without fiduciary duties on either side and is not, as some have suggested, a principal-agent relationship. In Part IV, I briefly examine how the Enron-era scandals shed further light on the arguments about shareholders' fiduciary duties. Finally, in Parts V and VI I discuss current trends in "shareholder activism" and how those trends should be understood in light of the law of fiduciary duties.

II. INTRODUCTION TO FIDUCIARY DUTIES, AGAIN

In order to decide whether some class of persons owes a fiduciary duty, one must understand when fiduciary duties generally apply. Because fiduciary duties arose in the ad hoc common law way, we do not have a clear explanation for their existence. However, it is generally accepted that what makes a fiduciary a fiduciary is her power to make decisions with regard to another person's property or person.⁸ Because of that power, the fiduciary must act in the best interests of the other person.⁹ A power creates a fiduciary duty if it enables the fiduciary to

7. For commentary addressing some of these issues, see *id.* (raising questions about institutional investor activity generally); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006) (noting the agency problems that exist between investment managers of institutional investors and the investors in the funds).

8. See *Wal-Mart Stores, Inc., v. AIG Life Ins. Co.*, 901 A.2d 106, 113-14 (Del. 2006); see also Dalley, *supra* note 2, at 208 n.183; see also STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 425 (2002) [hereinafter BAINBRIDGE, CORPORATION LAW] (describing fiduciary duties as a method of preventing "expropriation by the contracting party with control over the assets" of the other party); cf. Robert Flannigan, *Fiduciary Duties of Shareholders and Directors*, 2004 J. BUS. L. 277, 281 (arguing that fiduciary duties arise when one person has access to another's assets for a purpose limited by the other's direction); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426 (1993). One example of that situation is where the fiduciary has discretion over the property of another. See Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 ALA. L. REV. 1083, 1095 (2007).

9. RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958).

make decisions that are legally enforceable and can result in liability for the beneficiary.¹⁰ This is a “power” in the traditional Hohfeldian sense,¹¹ and it correlates to a resulting liability in the beneficiary.¹²

Although the fiduciary has the legal power to bind the beneficiary, the beneficiary sometimes has the legal right to control the fiduciary.¹³ That control is an essential feature of the agency relationship, for example.¹⁴ Other beneficiaries, however, do not have control over their fiduciaries. If a trust beneficiary tells her trustee to “invest in this great new stock I just read about in a chat room,” and the trustee refuses, the beneficiary has no legal redress.¹⁵ Similarly, corporations do not have control over their fiduciaries.¹⁶ Some principals, although they are legally empowered to exercise control, are in fact unable to exercise meaningful control over their agents because of a lack of knowledge or skill.¹⁷ Unsophisticated clients of attorneys and investment advisors are often, as a practical matter, completely at the mercy of their agents.

This difference in the degree of actual control that the beneficiary has over the fiduciary might account for differences in the nature of the fiduciary relationship and the strictness of

10. See Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 *YALE L.J.* 16, 44-47 (1913).

11. *Id.*

12. See *id.* Some fiduciaries, such as trustees and corporate directors, might be said to have a *right* to control, which would make them more powerful (in the colloquial sense) and perhaps subject to stricter duties, as discussed below.

13. See RESTATEMENT (SECOND) OF AGENCY § 1(1).

14. See *id.* (“Agency is the fiduciary relation which results from manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.”); Deborah A. DeMott, *Disloyal Agents*, 58 *ALA. L. REV.* 1048, 1050-51 (2007).

15. A trust beneficiary’s remedies are limited to specific enforcement of the trust, claims for breach of trust, appointment of a receiver, or removal of the trustee. See III AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *SCOTT ON TRUSTS* § 199 (4th ed. 1988). However, the beneficiary’s lack of legal control over the trustee can be inferred from the fact that a beneficiary need not have the capacity to make a contract. See 2 AUSTIN W. SCOTT, ET AL., *SCOTT & ASCHER ON TRUSTS* § 12.5 (5th ed. 2006). Also, the beneficiary ordinarily has no power to remove a trustee. See SCOTT & FRATCHER, *supra*, § 11.10.3; RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. g, at 43 (Tentative Draft No. 2, 2001).

16. The primary beneficiary of a corporate board’s fiduciary duties is the corporation. See *infra* note 52. Of course, the corporation cannot exercise control because it is not a real person. Thus, a corporate board is not an agent. Rather, its powers are “original and undelegated.” See *People ex rel. Manice v. Powell*, 94 N.E. 634, 637 (N.Y. 1911); see also *infra* Part III.B.

17. Cf. Maksym Burlaka, *Bank Corporate Governance: The Emerging Ukrainian Market Compared to International Best Practices*, 11 *FORDHAM J. CORP. & FIN. L.* 851, 862 (2006) (arguing that in the corporate governance context, shareholders often “lack the expertise to monitor and assess the work of managers”).

its rules,¹⁸ such as the “no further inquiry” rule in trusts, which absolutely prohibits a trustee from transacting with the trust property even if the transaction would benefit the trust or the beneficiary.¹⁹ Similarly, until recently trustees had no duty to disclose information, however material, to beneficiaries unless the beneficiary inquired.²⁰ This is presumably because there was nothing the beneficiary could do with the information. However, control by a beneficiary over the fiduciary is not an essential feature of a fiduciary relationship.²¹ Only the fiduciary’s power to bind the beneficiary is necessary.²²

To give rise to a fiduciary duty, the fiduciary’s power over the beneficiary must be a legal one.²³ That is, it must create legal liability on the part of the beneficiary.²⁴ Many relationships are characterized by one person’s ability to affect the life and behavior of another *without* the ability to legally bind the other.²⁵ I call this “moral control.” Some close personal relationships, such as those between spouses or between parents and adult children, have this feature. Moral control is not the same as legal power. Consider the relationship between a person of weak character and a person of dominating will. The dominating personality may control the weaker one, even to the

18. It is sometimes said that partnership fiduciary duties are stronger than corporate duties. See *Donahue v. Rodd Electrotape Co.*, 328 N.E. 2d 505, 516 (Mass. 1975). I have argued elsewhere that this is not the case. See Dalley, *supra* note 2, at 191. However, there might be a justification for stricter partnership duties because partners are fully and personally liable for the acts of their partners, and because each partner is both an agent and a principal, so that one partner (as principal) cannot either legally or practically “control” another (as agent). See *id.* at 187-90. Neither of these is true for closely held corporations, and it is therefore inappropriate to apply partner fiduciary duties to close corporations, whether those duties are stricter or not. See *id.*

19. See John H. Langbein, *Questioning the Trust Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 934-35 (2005).

20. See RESTATEMENT (SECOND) OF TRUSTS §173 cmt. d (1959). Today, a trustee must disclose information where necessary to protect a beneficiary’s interests. UNIF. TRUST CODE § 813(a), 7C U.L.A. 239 (Supp. 2006). This would occur, perhaps, where the beneficiary might want to claim breach of fiduciary duty or otherwise seek equitable relief challenging the action of the trustee.

21. BLACK’S LAW DICTIONARY 1067 (Abridged 8th ed. 2004) (A fiduciary relationship is “[a] relationship in which one person is under a duty to act for the benefit of another on matters within the scope of the relationship.”).

22. See *e.g.* 26 CFR § 301.7701-6 (1991) (stating that there is no fiduciary relationship without power over the property over another).

23. See Hohfeld, *supra* note 10, at 46.

24. See *id.*

25. *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b(1) (2003) (describing general proposition of fiduciary relationships, including: duty to act for the benefit of the other, not to profit at the expense of the other, and not to delegate to a third person); RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(1), at 36 (Tentative Draft No. 2, 2001) (describing the agency relationship as one in which one of the parties is willing to act subject to the control of the other).

point of affecting decisions the weaker partner makes. But the power is not a legal one: If the dominant character purports to enter into a contract for the submissive one without authority or ratification, the law will not enforce the contract against the weak character. Correlatively, the stronger character is not subject to a duty to protect the interests of the other person.²⁶

This is not to say that moral control is never legally relevant. For example, the law has recognized that moral control – the “relation of trust and confidence” – can give rise to special duties in making contracts.²⁷ Moral control is also legally recognized in the law defining conflicts of interest.²⁸ Thus, where a director is accused of being “control[led] or dominate[d]” by an interested director, the first director is deemed to be tainted by the interest.²⁹ This is true even though the interested director’s power of control is not legally enforceable.³⁰ However, these are cases where the law is attempting to determine the quality of an actor’s decision-making ability – whether a contract is truly based on consent or whether a director was acting based on her own good faith judgment. Moral control is not relevant for deciding whether a person has legal power over another’s person or property such that the person owes a fiduciary duty.

III. THE RELATIONSHIP BETWEEN SHAREHOLDERS AND THE BOARD

A. *Actual Relationships*

I now proceed, at the risk of stating the obvious, to examine the legal relationship between the shareholders and the board. It is worth noting that there are a variety of *actual* relationships the shareholders and the board may have. In small corporations, for example, the shareholders and the directors may be the same

26. What fun would moral control be, if it had to be exercised in the best interests of the other party?

27. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 161(d) (1979) (noting that non-disclosure is equivalent to an assertion when it concerns a fact that a person is entitled to know because of a “relation of trust and confidence”). Some states recognize an “informal fiduciary duty” when a relation of trust and confidence exists. See *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 698 (Tex. App. 2006).

28. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 161(d) (1979) (stating that if a party does not disclose a fact, his trust is placed with high importance because there are only a limited number of instances where the non-disclosure is treated as an assertion).

29. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995).

30. See *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

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people.³¹ The relationship among those people will vary widely and may have no structure other than that required by law.³² In very large corporations, there may be no actual relationship at all between any of the shareholders and the board, except to the extent the board members themselves own shares and to the extent the occasional shareholder shows up at the annual meeting.³³ The company will have an “investor relations” page on its website, but it may take a shareholder a while to even find the information. The shareholders have invested in the hope that the company will make money, but they do not care how the company accomplishes that goal.³⁴ As many others have pointed out, they are passive not only by choice, but because they lack the time, expertise, and incentive to participate in management.³⁵ This will especially be true if their holdings are highly diversified. They rely on the board to make business decisions based on the board’s judgment and expertise, not based on some idea of what the shareholders might want (other than profitability).³⁶ In this respect, one might say that the large publicly traded corporation functions as a republic rather than a democracy.³⁷

Even in large companies with dispersed shareholders, there are some matters that are of interest to the shareholders if only because the shareholders are required to vote on them: the election of directors, the amendment of the certificate of incorporation, and fundamental changes such as mergers and the sale of all or substantially all the assets.³⁸ The procedures applicable to such matters, such as voting structures and antitakeover devices, are also relevant to the shareholders.³⁹ In addition, any matter that reduces or enhances the likelihood that the board and management will in fact seek to maximize the profitability of the enterprise (rather than their own wealth) will

31. See, e.g., *E. Okla. Television Co. v. Ameco, Inc.*, 437 F.2d 138, 140 (10th Cir. 1971).

32. If the corporation has regular counsel, it may hold periodic meetings, either real or fictitious, of directors and shareholders.

33. See *Citibank, N.A. v. Data Lease Fin. Corp.*, 828 F.2d 686, 698 (11th Cir. 1987).

34. See *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 254 (7th Cir. 1986).

35. See Stephen M. Bainbridge, *Director Primacy and Shareholder Empowerment*, 119 HARV. L. REV. 1735, 1749-50 (2006) [hereinafter Bainbridge, *Director Primacy*]. Professor Bainbridge also notes that shareholder passivity has been a feature of corporate life for centuries. *Id.* at 1745 (arguing that “shareholders are rationally apathetic”).

36. *Id.* at 1746.

37. This is presumably the origin of the title of Vice Chancellor Strine’s reply to Professor Bebchuk. See Strine, *supra* note 7, at 1777. Cf. Bebchuk, *supra* note 5, at 837 (describing the American corporation as a “representative democracy”).

38. See *Dynamics Corp.*, 794 F.2d at 255-62.

39. See *id.*

be important to a shareholder who is paying attention.⁴⁰ Institutions, such as pension and mutual funds, are often shareholders who “pay attention” for a variety of reasons, and their “activism” has therefore attracted considerable scholarly attention.⁴¹ Even institutional shareholders will nevertheless be largely passive with respect to day-to-day, or even relatively major, management decisions.⁴²

Other smaller corporations may operate on a true democracy or oligarchic model. Most shareholders will have representation on the board, but the degree to which they have influence will vary widely.⁴³ In businesses owned by entrepreneurs and venture capital investors, for example, the relationship between the shareholders will be highly structured by contract, and the venture capitalists may expect to have direct input on business matters in some circumstances.⁴⁴ In family businesses, on the other hand, the patriarch or matriarch may completely dominate decision-making with the expectation that the other owners (who may be second or third generation family members) will tag along as best they can.⁴⁵

B. *Legal Relationship: Principal and Agent?*

The *actual* relationship between shareholders and boards can be and has been carefully examined from economic,⁴⁶ behaviorist,⁴⁷ financial,⁴⁸ and other perspectives. The *legal* relationship between shareholders and boards must, however, be examined from a legal perspective. That legal relationship is superimposed on the actual relationship (if any) between the board and the shareholders. As noted above, the shareholders

40. See *id.* at 254-58.

41. See *infra* Part V.

42. See, e.g., Bainbridge, *Director Primacy*, *supra* note 36, at 1752.

43. See O'NEAL & THOMPSON, *supra* note 1, § 7.2.

44. See Joseph A. McCahery & Erik P.M. Vermeulen, *Corporate Governance and Innovation: Venture Capital, Joint Ventures, and Family Businesses* 27-28, 42-47 (ECGI Working Paper Series in Law No. 65/2006, 2006), available at <http://ssrn.com/abstract=894785>.

45. See *id.* at 35-37; see also Phred Dvorak & Jaclyn Badal, *Relative Problems*, WALL ST. J., July 24, 2006, at B1.

46. See, e.g., Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 859 (1997) [hereinafter Bainbridge, *Community and Statism*].

47. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993).

48. See, e.g., Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2004); Bebchuk, *supra* note 5, at 833.

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elect the directors and vote on fundamental matters.⁴⁹ Other than that, the shareholders have no legal role in the corporation and no further legal relations with the directors.⁵⁰ They can bring a derivative suit and thereby attract the attention of the board, but there is no requirement that the board make itself available for shareholder input.⁵¹ In short, the shareholders have no legal position vis-à-vis the corporation other than the contractual one established by the articles of incorporation.⁵²

On the other hand, the directors have a legal relationship to the corporation: they are fiduciaries of the corporation because they have legal power over the corporation⁵³ (or, if you prefer, the assets and legal rights and obligations that comprise the corporation). To whom are the directors' fiduciary duties owed? The law clearly describes those duties as owed to the corporation and all of the corporation's shareholders.⁵⁴ Most of the time this proposition is not particularly troublesome as a practical matter. The shareholders are the ultimate, residual beneficiaries of the corporate enterprise. If the corporation is profitable, the shareholders' investment will increase in value and everyone will be happy even if that profit is achieved by considering interests other than the shareholders' interests.⁵⁵ Unfortunately, this fact has gotten caught up in a policy debate between those who believe that corporate boards can or should consider, or in some cases prefer, other interests (such as those of employees, customers, and all future life on the planet) to those of the shareholders.⁵⁶ Reacting to this position, others have argued for a "shareholder primacy norm" that requires that boards consider shareholders, and only shareholders, in pursuing corporate policy.⁵⁷

Of course, if shareholders' interests are primary, then the primary problem of corporate governance is the "agency problem" of boards and management preferring their own interests to

49. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559 (2003) [hereinafter Bainbridge, *Means and Ends*].

50. See *id.* at 574.

51. See *id.*

52. See *id.*

53. See *id.* at 548, 550.

54. See *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954 (Del. 1985); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); see also MODEL BUSINESS CORPORATION ACT § 830 (a)(3) (1984).

55. See, e.g., Bainbridge, *Director Primacy*, *supra* note 36, at 1753.

56. See Bainbridge, *Means and Ends*, *supra* note 50, at 549; see also Bainbridge, *Community and Statism*, *supra* note 47, at 877.

57. See Bainbridge, *Means and Ends*, *supra* note 50, at 563 (discussing director versus shareholder primacy).

those of the shareholders. Thus, the shareholder primacy norm has led by extension to the idea that shareholders should have the power to control the board in order to minimize these agency costs.⁵⁸ This use of the word “agency” has even led some people to refer to the shareholders as “principals” and boards as “agents” of the shareholders.⁵⁹ Principals have the right to control their agents, and agents owe fiduciary duties to their principals. Thus, the use of agency law terminology supports the proposition that shareholders should have more control over boards than shareholders have now, and that boards should seek to advance only the interests of the shareholders.⁶⁰ However, this “principal/agent” analysis is simply and unequivocally wrong as a legal matter.

As is often the case, the two sides of the so-called shareholder/stakeholder debate have taken their arguments to untenable extremes. No sane business person would suggest that a board should ignore the interests of the corporation’s employees and customers in order to enhance shareholder value. The idea is oxymoronic. Similarly, no sane person should expect the board of a for-profit corporation intentionally to reduce long-term shareholder value in order to improve the lot of workers or whales. In many instances, a concern for the interests of employees, customers, and even the general public will improve the profitability of the business and therefore enhance shareholder value.⁶¹ It is only in rare (but often high-profile) instances, such as hostile takeovers, that a board’s seeking to protect the long-term interests of the “business” and its non-shareholder constituents might adversely affect the shareholders’ ability to realize value on their investments.⁶²

58. See Bebachuk, *supra* note 5, at 908.

59. See, e.g., Joshua Ronen & Varda Yaari, *Demand for the Truth in Principal-Agent Relationships* (Dept. of Accounting, Taxation and Bus. Law, Stern Sch. of Bus., N.Y.U. & Dept. of Bus. Admin., Sch. of Mgmt., Ben-Gurion University) available at <http://ssrn.com/abstract=918055>; WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 97 (2003) (referring to the board as a “quasi-principal” and as the “economic agent” of the shareholders); see also *infra* Part III notes and text.

60. See generally Bebachuk, *supra* note 5; Ronen & Yaari, *supra* note 61.

61. See BAINBRIDGE, CORPORATION LAW, *supra* note 8, at 413; Olubunmi Faleyé & Emery Trahan, *Is What’s Best for Employees Best for Shareholders?*, 5 (May 2006), available at <http://ssrn.com/abstract=888180>.

62. An egregious example of this occurred in *Paramount Commc’ns, Inc. v. Time Inc.*, when the Time board denied the shareholders the opportunity to sell their shares at a 400% premium in order, they said, to protect the long-term interests of the company, including its editorial “culture.” 571 A.2d 1140, 1446, 1149 (Del. 1989); see also BAINBRIDGE, CORPORATION LAW, *supra* note 8, at 412-13 (discussing *Schlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. 1968) (rejecting the minority shareholder’s demand to build

Identifying the interests that the board should consider in carrying out its fiduciary responsibilities is not the same, however, as identifying the beneficiary of that fiduciary duty. A trustee, for example, is supposed to seek to effectuate the settlor's intent.⁶³ The settlor is not, however, the beneficiary of the trust.⁶⁴ Similarly, the trustee owes a fiduciary duty to the trust beneficiaries, but those beneficiaries do not ordinarily have any right to control the acts of the trustee.⁶⁵ Thus, the shareholder/stakeholder debate does not necessarily have anything to do with the board's fiduciary duties, and the merits of the shareholder/stakeholder debate are not relevant here. The point is to identify the legal relationship between the board and the shareholders without allowing the extra-legal rhetoric and economic jargon to mislead us.

Is the board the agent of the shareholders? An agent is a person who has agreed to act on behalf of another person (the principal) and is subject to that person's control.⁶⁶ The principal has a complete right of control over the agent, which serves to offset the fact that the principal is vicariously liable for all the acts of the agent.⁶⁷ The agent owes fiduciary duties to the principal, including the duty to turn over to the principal all profits or other benefits arising from the relationship.⁶⁸ The relationship between shareholders and directors has none of these features, and it should therefore be apparent that a board is not an agent of the shareholders.⁶⁹

Unfortunately, the idea that shareholders are the board's principal has acquired some authority. A few courts have used the language of principal and agent when discussing the relationship between the shareholders and the board.⁷⁰ The most important of these cases is *Blasius Industries v. Atlas Corp.*, in which Chancellor Allen held that a board needed a compelling

stadium lights at Wrigley field for night games because it would hurt the team's long term relationship with the surrounding neighborhood)).

63. See *supra* Part III.A.; SCOTT & FRATCHER, *supra* note 15, § 232, at 7 (noting that the terms of the trust can determine how a trustee should balance the interests of multiple beneficiaries).

64. SCOTT ET AL., *supra* note 15, § 12.4, at 706.

65. See DeMott, *supra* note 14, at 1052.

66. See RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958).

67. DeMott, *supra* note 14, at 1051.

68. See, e.g., *id.* at 1053.

69. See RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt.f(2), at 37 (Tentative Draft No. 2, 2001); DeMott, *supra* note 14, at 1051-52.

70. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659-60 (Del. Ch. 1988); *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1128 (Del. 2003).

justification to interfere with a shareholder vote for directors.⁷¹ In addition to noting the importance of the shareholder franchise to the “legitimacy of directorial power,”⁷² the Chancellor stated that “a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, *as between the principal and the agent*, has authority with respect to a matter of internal corporate governance.”⁷³ Moreover, that “will be true in every instance in which an incumbent board seeks to thwart a shareholder majority.”⁷⁴ Judicial review of a board’s interference with a shareholder vote “involves a determination of the legal and equitable obligations of *an agent towards his principal*. This is not . . . a question that a court may leave to the *agent* finally to decide”⁷⁵ Although the Delaware Supreme Court has approved the “basic tenets” of *Blasius*, it has generally done so with reference to the legitimating power of the shareholder franchise, not with reference to the Chancellor’s use of agency law.⁷⁶ The exception to this appears in *MM Companies, Inc. v. Liquid Audio, Inc.*, in which the Supreme Court quoted, without comment, a long passage from *Blasius* that includes the language quoted above describing the shareholders as the board’s principal.⁷⁷

If the shareholders were the board’s principal, then the board would be obligated to obey the shareholders’ wishes without considering other interests and without exercising independent judgment.⁷⁸ This is a result that many people

71. See *Blasius*, 564 A.2d at 661.

72. *Id.* at 659.

73. *Id.* at 659-60 (emphasis added).

74. *Id.* at 660. Arguably, under the Chancellor’s reasoning a board would need a compelling justification to, for example, refuse to approve an amendment to the certificate of incorporation that had been approved by a majority vote of the shareholders. *But see* Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 42-45 (2004) (arguing that the board has a duty to make an independent determination about proposals receiving majority shareholder approval, but not discussing *Blasius*).

75. *Blasius*, 564 A.2d at 660 (emphasis added).

76. See *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1378 (Del. 1995) (describing the franchise as the “essence of corporate democracy”); *Paramount Commc’ns. v. QVC Network Inc.*, 637 A.2d 34, 42 (Del. 1994) (referring to the “overriding importance of voting rights”); *Centaur Partners IV v. Nat’l Intergroup, Inc.*, 582 A.2d 923, 927 (Del. 1990) (describing the franchise as the “ideological underpinning upon which the legitimacy of directorial power rests”); *Preston v. Allison*, 650 A.2d 646, 649 (Del. 1994) (describing the franchise as “a fundamental part of our corporate law”).

77. *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1128 (Del. 2003).

78. Even under *Blasius*, such a relationship might be limited to governance matters and not extend to the board’s actions with respect to the operation of the business. See *Blasius*, 564 A.2d at 660.

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would prefer, but it is clearly not the law. In *Unisuper Ltd. v. News Corp.*, Chancellor Chandler argued that the contract in question, which bound the board not to renew a poison pill without shareholder approval, was valid despite the fact that it sterilized the board's discretion, a feature that ordinarily invalidates a contract.⁷⁹ The court reasoned, among other things, that the contract essentially permitted the shareholders, as principals, to make their wishes known to their agents, the board.⁸⁰ A month later, in further proceedings in the same case, the Chancellor described the earlier discussion as an "analogy" to agency law principles, noting that shareholders "rarely speak with one voice," and observing that there may be times when a director's duty to the corporation requires her to act against the shareholders' immediate wishes.⁸¹ The board is obligated to exercise its own judgment and cannot abdicate its responsibilities by tossing decision-making into the shareholders' collective lap.⁸²

Legally speaking, the principal of the board, and of anyone else exercising corporate powers, is the corporation.⁸³ While the idea of the corporation as a separate legal person is now often ridiculed as an outmoded over-simplification at best,⁸⁴ it is a handy shorthand term for the multitudinous interests involved in the profit-making enterprise. Even leaving other "stakeholders" out of the picture, the shareholders still do not represent the sole corporate interest. Unless there is only one shareholder, the shareholders do not have a single unitary interest and cannot be treated as a corporate "principal" with the board as its agent. Even if the shareholders did have a single interest, any subset of the shareholders (i.e., a majority) would still be at best an agent of the whole group, and not a principal. Moreover, the board's authority extends to the assets legally owned by the corporation, not by the shareholders.⁸⁵ The shareholders have no power over

79. *Unisuper Ltd. v. News Corp.*, 2005 WL 3529317, at *8 (Del. Ch. 2005).

80. *Id.*

81. *Unisuper Ltd. v. News Corp.*, 2006 WL 207505, at *3 (Del. Ch. 2006).

82. *See Paramount Commc'ns, Inc., v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989).

83. *See Victor Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1074 n.4 (1983). On the other hand, when the board is negotiating a transaction that will result in the shareholders' interests in the corporation being sold or converted, the board is literally acting on behalf of the shareholders, not the corporation, and is therefore the shareholders' agent. *See In re Cox Commc'ns, Inc., S'holder Litig.*, 879 A.2d 604, 618-19 (Del. Ch. 2005); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 109 n.52 (Del. Ch. 1999).

84. *See, e.g., Lonny Sheinkopf Hoffman, The Case Against Vicarious Jurisdiction*, 152 U. PA. L. REV. 1023, 1031 n.28 (2004).

85. *See Mechele Dickerson, A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 7 (2003).

the corporate property and therefore could not delegate that power to the board or anyone else.⁸⁶ The shareholders also have no liability for the board's actions, unlike a principal.⁸⁷ In sum, the relationship between shareholders and the board bears none of the indicators of a principal/agent relationship.⁸⁸

C. *The Corporate Contract: Corporate Primacy v. Duties to Shareholders*

Although the board and shareholders are not in a principal/agent relationship, they are clearly in a contractual relationship, a fact which has been recognized at least since *Trustees of Dartmouth College v. Woodward*.⁸⁹ The certificate of

86. There are some cases that treat the board as a delegate of the shareholders. See *Grimes v. Donald*, No. CIV. A. 13358, 1995 WL 54441, at *7 (Del. Ch. Jan. 11, 1995); *Alford v. Shaw*, 349 S.E.2d 41, 51 (N.C. 1986); *Appeal of Armed Forces Co-op. Insuring Assn.*, 625 P.2d 11, 16 (Kan. App. 1981); *Moore v. Conover*, 195 A. 833, 838 (N.J. Eq. 1937); *Severance v. Heyl & Patterson, Inc.*, 187 A. 53, 58 (Pa. Super. 1936). This has always been wrong - corporations and board powers are established by legislative act, and shareholders have not always even had the power to choose the members of the board. The Dutch East India Company (the VOC), for example, one of the world's first modern business corporations, was organized by the Dutch States General in 1602 as a combination of smaller, city-based companies. See Ella Gepken-Jager, *Verenigde Oost-Indische Compagnie (VOC): The Dutch East India Company, in VOC 1602-2002: 400 YEARS OF COMPANY LAW* 41, 47 (Ella Gepken-Jager et al. eds., 2005). The business was managed by directors, who were appointed by governors representing the several cities ("chambers") included in the combination. See *id.* at 54-55. The governors were initially appointed by the States General. *Id.* at 52-56. Thereafter, they were supposed to be elected by large shareholders in each chamber but in practice they simply appointed their own successors. See *id.* at 55-56. As a result of complaints from investors, some accountability structures were put in place, but they protected only the "major shareholders." See *id.* at 57. The Danish East India Company, established in 1616, did away with the chamber system in favor of direct selection of the governors by the "general meeting" of the shareholders. See Karsten Engsig Sørensen, *The Danish East India Company, in VOC 1602-2002: 400 YEARS OF COMPANY LAW* 107, 107, 113 (Ella Gepken-Jager et al. eds., 2005). However, that system quickly changed to one where shareholder control was made more indirect. *Id.* at 113-18.

87. See Constance Z. Wagner, *Structuring the Financial Service Conglomerates of the Future: Does the Choice of Corporate Form to House New Financial Activities of National Banks Matter?*, 19 ANN. REV. BANKING L. 329, 399 (2000).

88. See Henry Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195, 1213.

89. 17 U.S. 518, 627 (1819); see also *Rogers v. Lafayette Agric. Works*, 52 Ind. 296, 303-04 (1875) (stating that purchase of stock constitutes a shareholder's agreement to management by the board of directors). This contract may be somewhat fictitious in large or established companies, where the contract was entered into by persons far removed from the current shareholders. Cf. *Bebchuk*, *supra* note 5, at 862-65, 888-90 (describing lack of shareholder power to amend or control amendments to the charter); ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 186-95 (1933) (also describing lack of shareholder power to amend or control amendments to the charter). Nevertheless, the shareholders' participation in every corporation actually

incorporation is a contract that binds the shareholders and the board, subject to the requirements of the incorporation statute of the state of incorporation.⁹⁰ Identifying the relationship between the board and the shareholders as contractual does not tell us much, of course - agency is often created by a contractual relationship as well. It is probably possible to create a corporation that includes an agency relationship between the board and the shareholders, but most corporate charters do not create any identifiable relationship between the parties other than shareholder/director. Pursuant to the corporate contract, the shareholders commit capital to the operation of a business, and the statute provides that the business will be managed by a board of directors.⁹¹ They are, as Professor Bainbridge has described it, joined in the corporate nexus.⁹² The shareholders have the right by statute to select and remove the board.⁹³ This provides at least some protection for their investment. They also have the right to approve fundamental changes,⁹⁴ which are in effect amendments of the basic contract. These are important rights that courts will protect strenuously.⁹⁵ However, they are rights created by the statute and charter and are therefore part of the corporate contract. Unless a contract expressly provides otherwise, it does not give one party the right to control what the other party does. Contracts also do not, in themselves, give rise to fiduciary duties.⁹⁶ Thus, identifying the relationship as a contractual one also tells us nothing about the amount of control the shareholders have over the board. Only the terms of the contract can tell us that, and most of the relevant “terms” of the

originates with the filing of the (contractual) charter. The corporate contract is therefore much more real than the social contract purportedly legitimizing government.

90. See Note, *Constitutional Rights of the Corporate Person*, 91 YALE L.J. 1641, 1647 n.29 (1982).

91. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2007).

92. See BAINBRIDGE, *CORPORATION LAW*, *supra* note 8, at 200.

93. See Charles H. Steen & Michael B. Hopkins, *Corporate Governance Meets the Constitution: A Case Study of Nonprofit Membership Corporations and Their Associational Standing Under Article III*, 17 REV. LITIG. 209, 220 (1998).

94. Joshua D. Fulop, Comment, *Agency Costs and the Strike Suit: Reducing Frivolous Litigation Through Empowerment of Shareholders*, 7 J. BUS. & SEC. L. 213, 225 (2007).

95. See *McIlquham v. Feste*, 2002 WL 244859, at *17-18 (Del. Ch. Feb. 13, 2002); *Rohe v. Reliance Training Network, Inc.*, No. 17992, 2000 WL 1038190 at *10 (Del. Ch. July 21, 2000) (directors must be elected regularly and can be removed by the shareholders without limitation).

96. Cf. *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 901 A.2d 106, 114 (Del. 2006).

contract among the shareholders, the board, and the corporation are set by law.⁹⁷

The primary legal determinant of the relationship between the shareholders and the board is embodied in provisions such as Section 141(a) of the Delaware General Corporation Code, which provides that “the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.”⁹⁸ Because the board’s duties are owed to the “corporation” or the shareholders as a group, the board should seek to enhance the profitability of the corporation.⁹⁹ Because the shareholders are the residual claimants on the corporate assets, they comprise “the corporation” when everyone else is gone.¹⁰⁰ The method used to enhance profitability, and the appropriate time horizon, are matters for the board’s discretion.¹⁰¹ Not only do the shareholders not have the power to interfere in the board’s management,¹⁰² but the shareholders’ power to hold the board to account for its actions is also limited by the business judgment rule, among other things.¹⁰³ What should a board do when the interests of the corporation – that is, profit maximization – conflict with those of a shareholder or group of shareholders? This situation arises in a number of ways.

There are the occasional well-known cases involving socially responsible shareholders who seek to have the corporation cease some profitable but socially injurious line of business, in which the courts usually rule that such decisions are within the purview of the board.¹⁰⁴ There are also the takeover cases, which state that a board may take action against a shareholder who poses a threat to “corporate policy and effectiveness” if the board’s response is proportionate to the threat and not intended

97. Whether those terms are mandatory or subject to change by agreement of the parties is not relevant to this analysis.

98. DEL. CODE ANN. tit. 8, § 141(a) (2007); see *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000).

99. Lyman Johnson & David Millon, *The Case Beyond Time*, 45 BUS. LAW. 2105, 2108 (1990).

100. Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 538 (2006).

101. *Cf. Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954 (Del. 1985).

102. See *Paramount Commc’ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994); *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85,*2 (N.H. 1880).

103. See BAINBRIDGE, *CORPORATION LAW*, *supra* note 8, at 207.

104. See, e.g., *State ex rel. Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406, 412 (Minn. 1971) (holding that attempting to force Honeywell to stop manufacturing fragmentation bombs was not a proper purpose for a shareholder’s books and records request).

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to protect the incumbent directors' positions.¹⁰⁵ Other cases have stated, at least in dicta, that a board can thwart the will of a majority of the shareholders, or even of a sole majority shareholder, if it has a sufficiently compelling reason for doing so.¹⁰⁶ This rule would be absurd if the board's duties were owed directly to the shareholders.

The rule requiring a director to act in the best interests of the corporation even if doing so is contrary to the wishes of a subset of shareholders is consistent with the rule that a contract is invalid if it sterilizes the board's discretion to act consistently with its fiduciary duties, unless *all* the shareholders agree and the corporation's creditors are protected.¹⁰⁷ To prefer the interests of some shareholders to the interests of the corporation as a whole (which embodies the common wealth-maximizing interests of all the shareholders, even if it does not embody the peculiar interests of particular shareholders), would be to act against the interests of the remaining shareholders.¹⁰⁸ Similarly, the law is clear that a board must protect the interests of a minority shareholder from injury caused by a majority shareholder.¹⁰⁹ Even a director who was named to the board by a specific shareholder is obligated to act in the interests of all the shareholders or the corporation as a whole,¹¹⁰ and can, unless the charter specifies otherwise, be removed for cause by the other shareholders.¹¹¹ In other words, she is a fiduciary of the corporation, not the shareholder who appointed her.

There are, however, a few cases that seem to contradict the corporate-primacy principle. In *VGS, Inc. v. Castiel*,¹¹² the board of the company (an LLC) consisted of three directors: the

105. See *Unocal*, 493 A.2d at 955.

106. See *Hollinger, Inc. v. Hollinger Int'l, Inc.*, 858 A.2d 342, 387 (Del. Ch. 2004) (excluding majority shareholder from vote on major transaction); *Mendel v. Carroll*, 651 A.2d 297, 299, 304, 306 (Del. Ch. 1994); *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988) (blocking shareholder vote for directors); *Phillips v. Insituform of N. Am., Inc.*, 1987 WL 16285 at *6-8 (Del. Ch. Aug. 27, 1987) (explaining a board's need to justify its actions when expressly depriving shareholder rights).

107. See *supra* note 88 and accompanying text.

108. See Charles R.T. O'Kelley, *Symposium: Robert Clark's Corporate Law: Twenty Years of Change: The Entrepreneur and the Theory of the Modern Corporation*, 31 IOWA J. CORP. L. 753, 755 (2006) (discussing the nexus-of-contracts model of corporate law under which "the defining purpose of corporation law is shareholder wealth maximization").

109. See, e.g., *McMullin v. Beran*, 765 A.2d 910, 919-20 (Del. 2000); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

110. See, e.g., *McMullin*, 765 A.2d at 923; *Phillips*, 1987 WL at *10; *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

111. See *Rohe v. Reliance Training Network, Inc.*, 2000 WL 1038190, at *13 (Del. Ch. July 21, 2000).

112. 2000 WL 1277372 (Del. Ch. Aug. 31, 2000).

majority shareholder (Castiel), his designee, and the minority shareholder.¹¹³ The minority shareholder convinced the Castiel designee that Castiel's control was bad for the company, and they cooked up a scheme to eliminate his control.¹¹⁴ The court stated that "[m]any LLC employees, and even some of Castiel's lieutenants, testified that they believed it to be in the LLC's best interest to take control from Castiel."¹¹⁵ Nevertheless, the court held that the two members of the board had "failed to discharge their *duty of loyalty to [Castiel]* in good faith."¹¹⁶ The relevant fact in *VGS*, however, was that the board acted without notice to Castiel, another director, because if it had provided notice he would have instantly exercised his right to remove his designee from the board and appoint someone more loyal to him.¹¹⁷ In doing this, he would have been acting as a shareholder and he would not have been bound by fiduciary duties.¹¹⁸ In other words, the *secret* board action had the primary motive of depriving a shareholder of his right to vote for directors, which, under *Blasius*,¹¹⁹ constitutes a breach of the directors' duty in the absence of a compelling justification.¹²⁰

In other cases where individual shareholders or groups of shareholders had the right, by contract or pursuant to the certificate of incorporation, to appoint one or more directors, courts have recognized that those directors are intended to serve a specific function benefiting the individual shareholder and not necessarily the corporation as a whole.¹²¹ Courts have held that director-designees have the right to share information obtained

113. *Id.* at *1.

114. *Id.* at *2.

115. *Id.*

116. *Id.* at *4 (emphasis added). The Delaware Supreme Court has held that a board may act in a way that dilutes the interest of a majority shareholder if the board is acting for a proper corporate purpose. *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114, 121-22 (Del. 2006).

117. *VGS, Inc. v. Castiel*, 2000 WL 1277372, at *1-2. (Del. Ch. Aug. 31, 2000).

118. *See id.* at *4; *Pepsi-Cola Bottling Co. of Cincinnati v. Woodlawn Cannery, Inc.*, 1983 WL 18017 at *15 (Del. Ch. Mar. 14, 1983) (holding that a forty-four percent shareholder was entitled to vote in its own interest even if doing so caused substantial harm to the corporation).

119. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 651 (Del. Ch. 1988).

120. Professor Eisenberg convincingly argues that the board in *VGS* violated its duty of good faith by manipulating the corporate process in a way that violates corporate norms. *See* Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 51-57 (2006). He does not discuss *Blasius*. *See id.*

121. *See* *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, 1996 WL 307444 at *6 (Del. Ch. June 4, 1996) (noting that the purpose of the shareholder's right to designate a director was to protect the shareholder's interests, which were different from, and might conflict with, those of the corporation); *see also Benihana of Tokyo, Inc.*, 891 A.2d 150, 165 n.76, 166, 187 (Del. Ch. 2005) (discussing position of director-designees).

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from their board positions with the shareholders who appointed them,¹²² and that it was reasonable for a board to consult a forty percent shareholder before acting.¹²³ These are cases where the usual shareholder-director relationship was altered by contract. In such cases, the courts, at least in Delaware, seem to take a pragmatic approach, protecting the bargained-for rights of individual shareholders vis-à-vis the corporation, but protecting the corporation and other shareholders when those individual rights create conflicts that were not specifically foreseen or foreseeable at the time the special rights were established.¹²⁴ In sum, the fiduciary duties of the directors are owed to the corporation, not to any single shareholder or even to the shareholders as a group, unless the corporate contract provides otherwise.¹²⁵

IV. THE CLOSE CORPORATION SHAREHOLDER DEBATE, AGAIN

The Enron scandals have cast some interesting light on the debate over shareholder fiduciary duties. First, the arguments in favor of controlling shareholders owing fiduciary duties tend to be based on the vulnerable position of minority shareholders in closely held corporations, of whom the archetype is Euphemia Donahue.¹²⁶ Close corporations are usually defined as those with “a small number of stockholders, the absence of a market for the corporation’s stock, and substantial shareholder participation in the management of the corporation.”¹²⁷ In a close corporation, shareholders “usually expect employment and a meaningful role in management, as well as a return on the money paid for [their] shares.”¹²⁸ Because of the majority-rule nature of the corporation, the majority shareholder, through control of the

122. See *Moore Bus. Forms, Inc.*, 1996 WL 307444 at *4; *Kortum v. Webasto Sunroofs Inc.*, 769 A.2d 113, 121 (Del. Ch. 2000).

123. See *In re Western Nat'l Corp. S'holders Litig.*, 2000 WL 710192 at *8 (Del. Ch. May 22, 2000). But see *McMullin v. Beran*, 765 A.2d 910, 924 (Del. 2000) (holding that the directors must use independent judgment in making decisions regardless of the interests of the controlling shareholder).

124. Cf. *Moore Business Forms, Inc.*, 1996 WL 307444 at *6 (noting that conflict of interest was foreseen); *McIlquham v. Feste*, 2002 Del. Ch. LEXIS 8, at *7-8 (Del. Ch. Feb. 13, 2002) (refusing to protect the majority shareholder's right to control the board when the right had not been bargained for at the time the minority shareholder received the right to designate directors).

125. See *Strine*, *supra* note 7; *Brownstein and Kirman*, *supra* note 76, at 42-45; *Brudney*, *supra* note 85, at 1072, 1074 & n.4. The right of shareholders to elect and remove directors is, of course, part of the corporate contract.

126. See *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 511 (Mass. 1975).

127. *Moll*, *supra* note 1, at 888.

128. *Id.* (quoting *Thompson*, *supra* note 1, at 702).

board of directors, “has the ability to take actions that are harmful to the minority shareholders’ interests.”¹²⁹ “Standard [abusive] techniques include the refusal to declare dividends, the termination of a minority shareholder’s employment, the removal of a minority shareholder from a position of management, and the siphoning off of corporate earnings through high compensation to the majority shareholder.”¹³⁰ The minority shareholder is faced with an “indefinite future with no return on the capital he or she contributed to the enterprise,”¹³¹ and, unlike a shareholder in a public corporation, cannot “simply sell [his or her] shares on the market.”¹³²

In contrast, let us consider the situation of those fortunate shareholders in public corporations, such as the shareholder-employees of Enron or WorldCom. Most of their wealth was tied up in stock of their employer, and they were dependent for cash flow on employment by the company because the companies did not pay dividends.¹³³ They were at the mercy of management, who were able to extract cash from the company in ways the “minority” were not, such as through high compensation, other perquisites of office, and self-dealing.¹³⁴ When management’s wrongdoing was exposed, the shareholder-employees’ employment was terminated, their investments became worthless, and they had no ready market for their shares.¹³⁵ This is exactly the predicament in which Mrs. Donahue found herself.¹³⁶

One might argue that the Enron shareholder-employees made their own beds by failing to diversify their retirement account holdings. By investing solely or primarily in the stock of their employer, they voluntarily (although perhaps unwisely) sealed their fate. The same is true of “oppressed” shareholders in

129. *Id.* at 889.

130. *Id.* at 890.

131. *Id.* at 891 (quoting Thompson, *supra* note 1, at 703).

132. *Id.*

133. See Carrie Johnson & Robert Barnes, *Court Declines Enron Investors’ Appeal*, WASH. POST, Jan. 23, 2003 available at <http://www.washingtonpost.com/wpdyn/content/article/2008/01/22/AR2008012200966.html>.

134. See Bruce Mizrach, *The Enron Bankruptcy: When Did the Options Market Lose Its Smirk?* 8 (Whitcomb Ctr. For Research in Fin. Servs., Working Paper No. 06-29, 2006), available at <http://business.rutgers.edu/download.aspx?id=1217> (last visited Jan. 31, 2008).

135. *Id.* at 9-10.

136. See *Donahue v. Rodd Electrotpe Co.*, 328 N.E.2d 505, 511 (Mass. 1975) (Actually, Mrs. Donahue was better off than the Enron employees. She continued to hold shares in a valuable company, although she was unable to liquidate her investment at a price she liked. If she had retained her stock, she might eventually have earned a substantial return when the company was sold or liquidated.).

close corporations, however, who willingly (although perhaps unwisely) chose to invest as minority shareholders.¹³⁷ Furthermore, the fact of shareholder participation in management, which is generally treated as a feature of closely held corporations,¹³⁸ is rapidly increasing as a feature of publicly held corporations as well.¹³⁹ This phenomenon takes two forms, and each form raises a number of issues, as discussed below. It also serves to demonstrate that the argument in favor of shareholder fiduciary duties, based on the uniqueness of the position of shareholders in close corporations, rests on a false premise.¹⁴⁰

V. SHAREHOLDER ACTIVISM PART I

The more interesting post-Enron development involves the blossoming of shareholder activism, a bud that has hung tantalizingly from the vine for many years.¹⁴¹ The term “shareholder activism” is often used loosely to mean anything done by a shareholder in a public company other than passively voting with management.¹⁴² However, shareholder activism comes in two varieties: (1) efforts by institutional investors (usually mutual and pension funds) and reformers to improve corporate governance, often by removing anti-takeover devices;

137. Some minority shareholders wind up in that position because their public company has been taken over by a controlled corporation, but in that case the law governing takeovers protects them. See *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994). Some people inherit their minority shares, in which case it is difficult to see why they should not also inherit the unfavorable contractual position assented to by their forebears.

138. See, e.g., *Donahue*, 328 N.E.2d at 511-12; Moll, *supra* note 1, at 888.

139. See *Donahue*, 328 N.E.2d at 517.

140. I have made this argument previously; the Enron scandals merely illustrate my point. See *supra* note 2 and accompanying text.

141. In 1992, the SEC adopted new rules for disclosure of executive compensation intended to “improve shareholders’ understanding of all forms of compensation paid to senior executives and directors, the criteria used by the board of directors in reaching compensation decisions, and the degree of relationship between compensation and corporate performance” Executive Compensation Disclosure, Exchange Act Release No. 31327, [1992 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 85,056 at 83,416 (Oct. 16, 1992). On the same day, the SEC adopted rules to remove “unnecessary government interference in discussions among shareholders of corporate performance and other matters of direct interest to all shareholders.” *Regulation of Communications Among Shareholders*, Exchange Act Rel. No. 31326, Oct. 16, 1992, FED. SEC. L. REP. (CCH) 1992. It was widely understood that the latter set of rules would permit, if not encourage, increased involvement in corporate governance matters by institutional investors. See generally Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism*, 32 J. CORP. L. 681 (2007).

142. See Chee Keong Low, *A Roadmap for Corporate Governance in East Asia*, 25 NW. J. INT’L L. & BUS. 165, 185-86 (2004) (defining shareholder activism as “the exercise and enforcement of rights by minority shareholders”).

and (2) efforts by large individual investors or hedge funds to cause specific changes in the way the company is being run.¹⁴³ I discuss each of these in turn.

Lucian Bebchuk's proposal to give shareholders more power in corporate governance is a hot topic on the academic corporate law circuit these days,¹⁴⁴ and has even made it into the mainstream press.¹⁴⁵ Bebchuk proposes that shareholders be given greater power in "rules of the game" matters – changes to the governance provisions in the certificate of incorporation – which are traditionally within the shareholders' vetitive jurisdiction (although that jurisdiction is coincident with the board's jurisdiction).¹⁴⁶ He also proposes that shareholders be given the power to choose, in advance, to make certain business decisions,¹⁴⁷ and to initiate "end of the road" decisions such as sale or dissolution of the company.¹⁴⁸ Leaving aside the merits of these suggestions, the proposals raise questions about the fiduciary duties that would attend the shareholders' increased powers.¹⁴⁹ Shareholder power over rules-of-the-game decisions seems innocuous enough. Institutional investors have been making governance proposals for years.¹⁵⁰ As Bebchuk notes, those proposals often do not result in actual change, even when they receive a majority vote of the shareholders.¹⁵¹ This is because changes to the certificate of incorporation require board, as well as shareholder, approval.¹⁵² Bebchuk wants to change this rule.¹⁵³

As noted above, the certificate of incorporation is a contract to which shareholders are deemed to be parties by virtue of their share ownership.¹⁵⁴ Unlike most contracts, this contract can be changed without a party's consent (i.e., any individual

143. See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1045-46 (2007).

144. See generally Bebchuk, *supra* note 5; Bainbridge, *Director Primacy*, *supra* note 36; Strine, *supra* note 7, at 1759; Theodore N. Mirvis et al., *Bebchuk's "Case for Increasing Shareholder Power": An Opposition 1* (John M. Olin Ctr. For Law, Econs., and Bus., Discussion Paper No. 586, 2007), available at <http://ssrn.com/abstract=990057>.

145. See Joann S. Lublin, *Theory & Practice: Corporate Funding for Shareholder Activism?*, WALL ST. J. July 3, 2006, at B3.

146. See Bebchuk, *supra* note 5, at 865.

147. See *id.* at 892.

148. See *id.* at 895-96, 901-02.

149. Vice Chancellor Strine at least implicitly recognizes these problems. See Strine, *supra* note 7, at 1783.

150. See Kahan & Rock, *supra* note 145, at 1049.

151. See Bebchuk, *supra* note 5, at 852-56.

152. See DEL. CODE ANN. tit. 8, § 242(b)(1) (2001).

153. See Bebchuk, *supra* note 5, at 845-46.

154. See *Centaur Partners IV v. Nat'l Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990).

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shareholder), but it must be done with the approval of both the board and a majority of the shareholders.¹⁵⁵ The shareholders do not owe any duties when they do this, but the board does. In fact, the board's duties are heightened when tinkering with governance.¹⁵⁶ If a majority of the shareholders has the power to change the certificate unilaterally, the dissenting shareholders will lose the protection provided, at least theoretically, by the board's duty to act in the best interests of the corporation and all the shareholders.¹⁵⁷ While this problem may sound more theoretical than actual, it could cause real harm to dissenting shareholders.¹⁵⁸ In fact, the board's fiduciary duties are the only protection for minority shareholders in states that (correctly) do not impose duties on controlling shareholders.¹⁵⁹ If the shareholders gain the power to act unilaterally to legally bind all the other shareholders through an amendment to the corporate charter, they should also be subject to some corresponding duty. One option is to apply the contractual duty of good faith and fair dealing to shareholders' acting to change the certificate of incorporation. This rule would recognize that the shareholders are exercising a contract right that may affect the other parties'

155. *Id.* at 926-27.

156. *See* *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994); *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1378-79 (Del. 1995).

157. *See* *Kahan & Rock*, *supra* note 145, at 1074. The board's duty to prevent charter amendments that are not in the best interests of the corporation and all its shareholders is explored in *Brownstein & Kirman*, *supra* note 76, at 42-45. Some of the language in *Blasius* suggests that a board is always obligated to respect the expressed wishes of a majority of the shareholders on a corporate governance matter. *See* *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 660 (Del. Ch. 1988). Because the Delaware statute gives the power to initiate a charter amendment to the board, however, it would be odd, at least, to hold that the board did not have discretion in exercising that power. *See also supra* Part III.

158. Suppose I am a shareholder in a publicly traded company with a staggered board, and I like the staggered board because I do not want the company be taken over (perhaps because I live in the town where it has its headquarters, or because of my tax situation). In fact, I purchased the shares, and became subject to the terms of the certificate of incorporation, knowing about the staggered board. Corporate law allows those contract terms to be changed without my consent if the board and a majority of the shareholders agree. Although the majority of the shareholders can act selfishly to change the certificate, for example, to cause a short-term improvement in the price of the stock by increasing the likelihood of a takeover, the board must consider the interests of the corporation as a whole. It may believe, for example, that the staggered board, together with a poison pill, gives it power to negotiate with a bidder to protect shareholder interests in a takeover, and therefore refuse to remove the staggered board provisions. As a "minority" shareholder, I am protected by the board's veto. *See* *Mirvis et al.*, *supra* note 146, at 1-2.

159. *See* *McMullin v. Beran*, 765 A.2d 910, 920 (Del. 2000); *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994).

legitimate expectations under the existing contract.¹⁶⁰ Alternatively, the dissenting shareholders could be given appraisal rights, which is consistent with the current rule giving shareholders appraisal rights when they dissent from a merger.¹⁶¹

Bebchuk's "let the shareholders make business decisions" proposal¹⁶² is more troubling. Delaware law provides that shareholders may elect to manage the corporation in statutory close corporations, but when they do so they are subject to the same duties as directors.¹⁶³ This rule should apply to any shareholder or group of shareholders that takes control in lieu of the board, even in a public company, for the same reason: whoever has power over the corporate property owes a fiduciary duty to the corporation and all its shareholders. Bebhuk's proposal is somewhat less radical than full shareholder control. He proposes that shareholders be able to specify in advance that they (and not the board) will have the power to make certain business decisions, including those involving acquisitions, distributions, and executive compensation.¹⁶⁴ In effect, Bebhuk is trying to give the shareholders the power of a principal to control its agent, the board.¹⁶⁵ As noted above, this is not the existing legal relationship between the shareholders and the board. That relationship could be changed, of course, and that is the essence of Bebhuk's proposal.¹⁶⁶ Under that proposal, however, a group of shareholders – the majority – would be given power to bind, and therefore become the fiduciary of, the whole group or the corporation.¹⁶⁷

How might this work in practice? Bebhuk anticipates that the business decisions that shareholders are most likely to take

160. See STEVEN J. BURTON & ERIC G. ANDERSON, *CONTRACTUAL GOOD FAITH* § 2.3.3, at 54-55 (1995).

161. A merger is an example of a change in the fundamental terms of shareholders' investment without their consent. Originally, mergers required a unanimous vote of the shareholders. Appraisal rights compensated the shareholders for the loss of their veto power. See WILLIAM J. CARNEY, *MERGERS AND ACQUISITIONS* 19 (2000).

162. See Bebhuk, *supra* note 5, at 895.

163. See DEL. CODE ANN. tit. 8, § 351 (2001).

164. See Bebhuk, *supra* note 5, at 895.

165. *Id.*

166. *Id.*

167. In the usual case, a majority shareholder does not owe fiduciary duties because it does not have any legal power over anyone. See Dalley, *supra* note 2, at 207. Under Bebhuk's proposal, a majority of the shareholders would have legal power and should therefore be subject to concomitant duties. See Mirvis et al., *supra* note 146, at 3. If Bebhuk's model is truly the principal-agent relationship, and the shareholders are the true principal, then they should also be liable for the acts of their agents, a position no one has seen fit to take, at least in this context. See *id.*

over are those that are “game-ending” (such as a sale of the company) and “scaling down” (such as the spin-off of a division or a distribution of cash-on-hand),¹⁶⁸ because those are decisions in which agency costs between shareholders and management are particularly high.¹⁶⁹ However, he acknowledges that under his proposal any decision is eligible to be taken over by the shareholders.¹⁷⁰ So, for example, the shareholders of a corporation might add a provision to the certificate of incorporation requiring that the corporation distribute as a dividend all cash in excess of some amount.¹⁷¹ The point of this provision would be to prevent management from engaging in “empire-building.”¹⁷² The board, however, may believe that technological advances are likely to result in increased competitive pressures in the intermediate term, and that “hoarding cash” is important to protecting the long-term viability of the business.¹⁷³ Alternatively, the board may be (quietly) pursuing a business opportunity that would provide an attractive rate of return on a cash investment. In either case, the board will be unable to fulfill its fiduciary duty to act in what it believes to be the best interests of the corporation and all its shareholders, because a majority of the shareholders have eliminated its discretion with respect to certain aspects of the business.

This is a gross violation of fundamental corporate principles, which invalidate restrictions on the board’s ability to act consistently with its fiduciary obligations.¹⁷⁴ Although such a restriction in the certificate of incorporation would probably be valid under current law,¹⁷⁵ the certificate can only be amended with the board’s approval.¹⁷⁶ This approval is, itself, subject to fiduciary standards. Bebhuk’s proposal would give the power to

168. See Bebhuk, *supra* note 5, at 892.

169. See *id.* at 895.

170. See *id.*

171. See *id.* at 902.

172. See *id.* at 902-03.

173. See, e.g., William Echikson, *EU Advisor Faults Law Shielding VW*, WALL ST. J., Feb. 14, 2007, at A16 (describing Porsche’s war chest); see Aaron O. Patrick, *James Murdoch Opens the Wallet*, WALL ST. J., Aug. 18, 2006, at C1 (describing a typical conflict between management’s decision to invest in long term technologies at the expense of shareholder satisfaction in the short term).

174. See *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934); *Paramount Commc’ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 51 (Del. 1993). Nor would this provision fall under *Galler v. Galler*, which validated restrictions on the directors that were agreed to by all the shareholders. *Galler v. Galler*, 203 N.E.2d 577, 585 (Ill. 1964).

175. See DEL. CODE ANN. tit. 8, §§ 102(b)(1), 141(a) (2001).

176. See *id.* § 242(b)(1).

hamstringing the board to a majority of the shareholders acting unilaterally.¹⁷⁷

When a board makes decisions, it has a fiduciary duty to act in the best interests of the corporation and all its shareholders.¹⁷⁸ The decision is protected by the business judgment rule, however, if it is made by a fully informed and disinterested board acting in good faith.¹⁷⁹ What about the shareholders? Must their decision be fully informed, disinterested, and in good faith? Bebchuk's proposal does not suggest that the shareholders would be subject to any fiduciary duty in making their decision, nor that they would be under any obligation to become informed¹⁸⁰ or to make the decision in the best interests of the corporation.¹⁸¹ On the contrary, under current law shareholders are permitted to act completely selfishly when voting, even in the presence of conflicts of interest.¹⁸² Furthermore, it would be impossible to impose fiduciary duties on the ephemeral majority of shareholders who made the decision to amend the certificate.¹⁸³ The fact that the shareholders' decision to take control of an issue must occur in advance makes it even more difficult to hold them accountable for their decisions, since any adverse effects of their decision will not be felt until many of the outstanding shares will have changed hands. It also reduces the likelihood that the shareholders will be making informed decisions appropriate to the circumstances, and it removes the board's ability to act quickly with respect to those business matters the

177. Unsurprisingly, corporate executives have taken a dim view of giving shareholders control over even rules-of-the-game decisions, arguing that "[y]ou run the risk of a . . . board being unable to make bold decisions that are unpopular with any of these constituencies [e.g., pension funds, mutual funds, and hedge funds] but in the best interests of the company." Alan Murray, *CEOs Get Off the Ropes on Executive Pay*, WALL ST. J., July 5, 2006, at A2 (quoting John Castellani, President of the Business Roundtable).

178. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); see also MODEL BUSINESS CORPORATION ACT § 830 (a)(3) (1984).

179. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

180. The debate over Bebchuk's proposals has brought considerable attention to the question of whether shareholders *would* become adequately informed. See, e.g., Bebchuk, *supra* note 5, at 880-82; Bainbridge, *Director Primacy*, *supra* note 36, at 1745. I make a different argument: they *should* have a duty to become adequately informed.

181. See Bainbridge, *Director Primacy*, *supra* note 36, at 1755 n.98 (quoting Anabtawi's statement that "shareholders have significant private interests . . . [and] may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class").

182. See Kahan & Rock, *supra* note 145, at 1074.

183. Similar considerations have been used to argue against shareholder liability for a corporation's torts. See, e.g., Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190, 1197-98 (1967).

shareholders have chosen to govern. Bebchuk's proposal is troubling because it would give shareholders power without subjecting them to a concomitant duty and would thereby create an unaccountable power-holder, something previously unknown to fiduciary law.¹⁸⁴

VI. SHAREHOLDER ACTIVISM PART II

However interesting they may be, Bebchuk's proposals are merely proposals, and they are unlikely to become law anytime soon.¹⁸⁵ In the real world, other shareholders, primarily hedge funds, are seeking to participate in management by exerting direct moral control over the board, which raises questions about the fiduciary duties of the board members who may respond to that control.¹⁸⁶ Examples of this trend appear in the business pages every day, and include such corporate icons as General Motors, Time Warner, and McDonald's.¹⁸⁷ Because shareholders do not manage the corporation, these shareholders seek to control the board, using persuasion, threats, and public exhortation.¹⁸⁸ Often they succeed in placing one or more directors on the board.¹⁸⁹ As discussed above, unless otherwise provided by agreement, directors owe a duty to exercise independent judgment in the best interests of the corporation no matter who elected them.¹⁹⁰ When Kirk Kerkorian's hand-picked director on the GM Board votes the way Kerkorian wants him to

184. Moreover, one cannot argue that the shareholders are not subject to duties when exercising control because it is "their" property they are controlling – in other words, that they are the principal, not the agent, and they are merely seeking to control their agent, the board – for the reasons described in Part III above. *See supra* Part III.

185. Legislation has been proposed that would give shareholders the power to vote on executive compensation in some cases. *See generally* Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (as reported by House, Apr. 16, 2007). A few corporations have acceded to shareholder requests for a non-binding shareholder vote on executive compensation. *See* George Anders, 'Say on Pay' Gets a Push, But Will Boards Listen?, WALL ST. J., Feb. 27, 2008, at A2. This phenomenon is taking place through existing legal procedures, and dissenting shareholders are protected by the board's fiduciary duties.

186. *See* Kahan & Rock, *supra* note 145, at 1029-32.

187. For an excellent discussion of the phenomenon *see id.* at 1024-25, 1029-42; Briggs, *supra* note 143, at 695, 724-37; William M. Bratton, *Hedge Funds & Governance Targets*, 95 GEO. L.J. 1375, 1379, 1429-1433 (2007); Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation* 43-46 (Vanderbilt Univ. Law Sch., Working Paper No. 06-21, 2006; Univ. of San Diego Sch. of Law, Legal Studies Research Paper No. 07-72, 2006), available at <http://ssrn.com/abstract=931254>.

188. *See* Briggs, *supra* note 143, at 697-701.

189. *See id.* at 724-37.

190. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939); Zahn v. Transamerica Corp., 162 F.2d 36, 45-46 (3d Cir. 1947).

vote rather than exercising his own judgment, has the director violated a duty?¹⁹¹ These shareholders are not engaging in battles about repealing poison pills or appointing an independent lead director, matters which at least arguably relate to the balance of power between shareholders and the board and are therefore legitimate shareholder concerns.¹⁹² These are battles about the way the company is being run, including how best to realize value for the shareholders and whether to realize that value in the short term or long term.¹⁹³ In other words, these are decisions generally covered by the business judgment rule, as long as the board is reasonably informed and a majority of the board is disinterested, and the activist shareholders involved are really seeking to treat the board as their agents – that is, subject to their control.¹⁹⁴

There are a number of questions one might ask about this sort of shareholder activity. Is it un-American, violating the principles of corporate enterprise that helped make this nation great?¹⁹⁵ Is it a welcome check on the increasingly unresponsive management of public companies?¹⁹⁶ Does it cause a pointless waste of management time and attention because shareholders cannot possibly have the information, incentives, and expertise

191. This example is hypothetical. Kerkorian's director, Jerome York, has resigned and Kerkorian has liquidated his investment. Moreover, York had expertise in the industry and may very well have been selected by Kerkorian because he valued York's own judgment. Other GM directors expressed enthusiasm for York's presence. However, York's contract entitled him to four percent of any gains Kerkorian realized on his GM stock, so York's interests — and loyalties — were clearly intended to be aligned with Kerkorian's. See Monica Langley, *Newest Director Shakes Up GM with Calls for Radical Change*, WALL ST. J., Mar. 20, 2006, at A1; see also Paul Ingrassia, *Kerkorian Motors*, WALL ST. J., July 5, 2006, at A24 (describing York as Kerkorian's "adviser"). One member of the group of advisors Kerkorian placed on the boards of corporations he sought to control or acquire stated, "It's not about making your mark, it's about serving Kirk. . . . [The advisors] are there to do whatever Kirk asks them to do." Christina Binkley & Stephen Miller, *Remembrances*, WALL ST. J., April 21, 2007, at A6.

192. Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors*, 9 (UCLA Sch. of Law, Law & Econ. Research Paper Series, Research Paper No. 05-20, 2005), available at <http://ssrn.com/abstract=796227>.

193. See Kahan & Rock, *supra* note 145, at 1083-87 (discussing possible "short-termism" by hedge funds).

194. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

195. See Bainbridge, *Director Primacy*, *supra* note 36, at 1739-40 (stating that "the U.S. economy has performed very well . . . " due to the fact that the board of directors acts rationally and is disinterested).

196. See Kahan & Rock, *supra* note 145, at 1047; Bebchuk, *supra* note 5, at 862-65; see also Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785 (2003) (arguing that controlling shareholders can monitor management and serve to reduce agency problems between management and shareholders).

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necessary to make better decisions than current management?¹⁹⁷ Does it contribute to the rise of the “shareholder primacy norm” and therefore to the kind of behavior that led to the millennial financial scandals?¹⁹⁸ These are all interesting questions that are beyond the scope of this Article. My focus here is on two related issues: (1) What duties are owed by the representative of an activist shareholder on the board? (2) Does the activist investor risk liability when, as a shareholder, it interferes in management decisions?

As noted above, fiduciary duties arise from a person’s exercise of legal power over another’s person or property, but do not arise from moral control.¹⁹⁹ The fiduciary with legal power over the corporation is the board; a shareholder does not have legal power over the corporate property, although it may have moral control over members of the board.²⁰⁰ Shareholders, whether controlling or not, are not “principals” of the board and therefore have no legal control over the board.²⁰¹ Therefore, if they exercise control at all they must act by influencing the board.²⁰² Thus, the first issue is the duties owed by a shareholder’s designee on the board.

As discussed in Part III above, the board owes its duties to the corporation and all its shareholders.²⁰³ This is true not only for the board as a whole, but also for any single board member, including those designated by minority shareholders.²⁰⁴ One might argue that it is acceptable for such designees to represent their shareholders’ interests because, as minority board members, they cannot do harm and may do some good by presenting a different perspective that is less deferential to management. The latter argument has some merit, but the alternative perspective that the designee presents must be a perspective on what is best for the corporation or it will not add value to board decision-making. The former argument, that designees can be allowed to act as their shareholders direct because they pose no threat to the corporation, must be

197. See Bainbridge, *Director Primacy*, *supra* note 36, at 1745 (stating that “shareholders lack incentives to gather the information necessary to participate actively in decision making”).

198. See Karmel, *supra* note 6, at 7-9; Kahan & Rock, *supra* note 145, at 1083-87 (discussing “short-termism”); Partnoy & Thomas, *supra* note 189, at 24.

199. See *supra* Part II.

200. See *supra* Parts I and II; see also *supra* notes 190-92 and accompanying text.

201. See *supra* Part III.B.

202. See *supra* Part I.

203. See *supra* Part III.

204. See *supra* Part III.

considered in light of the process by which boards operate. Board members can act only as a group - a single board member has no authority to act for the corporation. Although most boards act by majority rule,²⁰⁵ in practice boards generally operate by consensus.²⁰⁶ Thus, a single director on a board of more than two will be not be legally able to cause the corporation to do anything.²⁰⁷

As a practical matter, some directors may exercise more moral control than others where, for example, the director is sufficiently persuasive and strong-willed and the rest of the board is malleable or deferential.²⁰⁸ In that case, the resulting board action will appear to have been – legally must have been – taken by the board as a whole, but it may be obvious that a single director or group of directors was the instigator of the decision. Lone directors occasionally make their individual views known, especially when they are dissenting from actions taken by the board.²⁰⁹ But in most cases, whether a designated director has exercised any real control in any given decision will be unknown,

205. See Del. Code Ann. tit. 8, § 141(b) (2001).

206. See Strine, *supra* note 7, at 5.

207. See Del. Code Ann. tit. 8, § 141(b).

208. See Joann S. Lublin & Erin White, *Drama in the Boardroom*, WALL ST. J., Oct. 2, 2006, at B1 (describing cases where minority board members were able to sway entire boards); Darian M. Ibrahim, *The Board as a Collective Body or a Collection of Individuals: Implications for Director Liability* 21, 24, 26 (Ariz. Legal Studies Discussion Paper No. 06-25, 2006), available at <http://ssrn.com/abstract=918119> (discussing situations in which a single director is likely to influence the outcome of a decision); Ingressia, *supra* note 193, at A24 (observing that if Carlos Ghosn, automotive management genius, were on the GM board he would have “enormous influence”). The fact that boards have responded to the demands of activist investors suggests that a shareholder-designee on a board, when backed by a noisy investor, may have considerable moral power. See Kahan & Rock, *supra* note 140, at 1029-30 (describing successful activism); Rob Cox, *Sage Advice? ‘Just Say No’*, WALL ST. J., July 6, 2007, at C10 (describing cases where board’s refusal to listen to activist investors led to unhappy results). *But see* Nikhil Deogun, Peltz, *Bottled Up, Might Not Shake Up Heinz*, WALL ST. J., Sept. 27, 2006, at A2 (noting that an activist investor might be constrained by board service). For an excellent discussion of the benefits and costs of board representation, and the observation that it must have value because hedge funds continue to seek it and incumbent boards resist it, see Briggs, *supra* note 138, at 709-20.

209. In 2004, the SEC adopted rules to require that issuers disclose the fact that a director has resigned because of a dispute with the board or management and publish any correspondence between the departing director and the issuer. See *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*, Securities Act Release 8400, Exchange Act Release 49424, [2003-2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,158, ¶ 89508 (Mar. 16, 2004). Describing the operation of the rule, former Chairman Harvey Pitt noted that part of its value was that it provided individual directors with “leverage,” presumably to be used to pressure boards to do the right thing. See Phyllis Plitch, *New SEC Rules Show Underbelly of Corporations*, WALL ST. J., Oct. 12, 2005, at B4A.

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and it will be the board as a whole that will be judged.²¹⁰ In other cases, the influence of a single director or small group of directors will be known publicly to have caused change.²¹¹ This is especially likely to occur when a director has a separate agenda, or when the shareholder who designated the director has been advocating the given course of action for some time.²¹² In that case, a director who is acting only as a mouthpiece for another person will face a greater liability risk than other directors.

As previously stated, shareholders' designees owe duties to the corporation and the shareholders as a whole.²¹³ The usual standard of care is generally stated to be that of the ordinary prudent person in the same or similar circumstances.²¹⁴ The operation of the business judgment rule protects a decision if it is made by an independent, informed board acting in what it believes in good faith to be the best interests of the corporation.²¹⁵ A director who does not exercise her own independent, informed judgment violates her fiduciary duty.²¹⁶

In Delaware, a breach of the duty of care generally involves gross negligence or a failure to become reasonably informed.²¹⁷ A director who does her shareholder's bidding without becoming

210. See Ibrahim, *supra* note 210, at 8-9. Delaware law is unclear whether each director's compliance with her fiduciary duties is to be judged separately, or whether the board is to be judged as a whole. See *In re Walt Disney Co., Deriv. Litig.*, 907 A.2d at 748 (2005); Ibrahim, *supra* note 210, at 21-22 (discussing potential liability where only one director breaches a duty of good faith).

211. See Ibrahim, *supra* note 210 at 26; Phred Dvorak and Jaclyne Badal, *Relative Problems*, WALL ST. J., July 24, 2006, at B1 (describing influence of members of founding families on company management); cf. *Siegman v. Tri-Star Pictures, Inc.*, 1989 WL 48746 at *3 (Del. Ch.) (refusing to infer control where shareholder had four of ten seats on board and power to veto transaction).

212. See Ibrahim, *supra* note 210, at 26-28; Steve Rosenbush, *Peltz Pours It On at Heinz*, (Aug. 17, 2006), http://www.businessweek.com/print/investor/content/aug2006/pi20060816_320681.htm.

213. See *supra* note 113 and accompanying text; see also, Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 DEL. J. CORP. L. 515, 555-58 (2001).

214. See, e.g., AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE §401(a) (1994).

215. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

216. See *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000); *Zahn v. Transamerica Corp.*, 162 F.2d 36, 46 (3rd Cir. 1947). Lest one think that all shareholder designees are in fact noble and independent-minded people who will not be influenced by the shareholder who nominated them, I note that when the Tribune Company board voted on its stock buyback, all seven independent directors and the CEO voted in favor, while the three directors appointed by the Chandler family (one of whom was Mr. Chandler) voted no. See Dennis K. Berman & Sarah Ellison, *Tribune Buyback Draws Opposition from Chandlers*, WALL ST. J., June 7, 2006, at A1. That seems remarkably coincidental.

217. See *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 748 (Del. Ch. 2005).

reasonably informed probably violates that duty.²¹⁸ Even if she becomes fully informed, if she fails to exercise her independent judgment she will have failed to act in good faith and thus breached her duty of loyalty.²¹⁹ The Delaware Supreme Court has recently stated that “A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation”²²⁰ A director’s act of following the instructions of a shareholder, rather than exercising her own judgment, falls squarely within this definition of bad faith.²²¹ Moreover, that failure to act in good faith can result in liability because it constitutes a breach of the duty of loyalty.²²² Incumbent directors have in fact used the prospect of such misplaced loyalty to fight shareholder nominees, arguing that they will not “think independently and vote their own conscience” or act as “independent voices accountable to all shareholders.”²²³ Conversely, designee directors have pledged to act in the best interests of all the shareholders.²²⁴

Moreover, a director who is “dominated and controlled” by an interested person is not considered independent of the interested person.²²⁵ A director is dominated and controlled when she is “beholden” to an interested person and “so under [that person’s]

218. See *Levco Alternative Fund Ltd. v. Reader’s Digest Ass’n., Inc.*, 2002 WL 31835461 at *3 (Del. 2002).

219. *Stone v. Ritter*, 911 A.2d 362, 369-71 (Del. 2006).

220. *Id.* at 369 (citing *In re Walt Disney Co.*, 906 A.2d, at 67).

221. See *ATR-KIM ENG Fin. Corp. v. Araneta*, 2006 WL 3783520, at *21 (Del. Ch. Dec. 21, 2006). This concern would not apply when the activist shareholder is herself sitting on the board, because she presumably made her investment, or decided to become active, out of a belief that her views constituted the best interests of the corporation, at least in some sense. See *Kahan & Rock*, *supra* note 140, 1087-89.

222. Even if such breaches rarely result in liability, the duty to act independently is important. Directors need to know what they are supposed to do even if they are unlikely to be sued for not doing it. See Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 *FORDHAM L. REV.* 1769, 1794-95 (2007).

223. See *Heinz Questions Peltz/Trian Director Slate*, Dow Jones Newswires, July 17, 2006; UPDATE: *Heinz Sharpens Criticism of Peltz Board Nominees*, Dow Jones Newswires, July 17, 2006; Aaron O. Patrick, *Bellore Quashes Talk of a Merger with Aegis, Havas Chairman, Instead, Seeks Partnership in Areas of Media Buying, Planning*, *WALL ST. J.*, June 23, 2006, at B3.

224. See Joann S. Lublin & Erin White, *Drama in the Boardroom*, *WALL ST. J.*, Oct. 2, 2006, at B1.

225. See *Brehm v. Eisner*, 746 A.2d 244, 257-58 (Del. 2000). Where the director herself is a large shareholder, she may or may not be considered an “independent director” for federal securities law purposes. See Donald C. Clarke, *Three Concepts of the Independent Director*, 32 *DEL. J. CORP. L.* 73, 91-94 (2007). The state law question of “disinterestedness” is determined with reference to a specific transaction, and therefore the director’s status will depend on the matter before the board. See Clarke, 32 *DEL. J. CORP. L.* at 105, 108-09.

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influence that [her] discretion would be sterilized.”²²⁶ Merely owing one’s position as a director to another does not make one beholden to that person,²²⁷ but having more substantial financial ties, such as where the director’s full-time employment was within the other’s control, does make one beholden to that person.²²⁸ “[I]t is the care, attention and sense of individual responsibility to the performance of one’s duties that touch on independence.”²²⁹ Thus, a director who is dominated and controlled by another will be considered interested where the other person is herself “interested.”²³⁰

“Interest” is usually defined as a financial interest not shared by other shareholders.²³¹ Broadly speaking, however, a conflict of interest can arise from any circumstance that impairs the director’s ability to make a decision “based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”²³² Thus, while a director-designee may not meet the usual definition of interest in a transaction not directly involving the designating shareholder, she probably is not independent either, in the sense of being free from extraneous influence.²³³ Moreover, in many cases the interests of the activist shareholder and those of all the shareholders as a group will diverge.²³⁴ If a majority of the directors is either interested or dominated and controlled by someone who is interested in a particular matter, the transaction will lose the protection of the business judgment rule, and the board will bear the burden of proving that the transaction was fair.²³⁵ Thus, transactions involving the activist shareholder can become major liability risks.

The foregoing analysis suggests that there are a lot of breaches of fiduciary duty occurring across corporate America.

226. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

227. *See Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 175, 177 (Del. Ch. 2005).

228. *See Carlson v. Hallinan*, 925 A.2d 506, 530 (Del. Ch. 2006).

229. *Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985) (citing *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984)).

230. *Kaplan v. Centex Corp.*, 284 A.2d 119, 123 (Del. Ch. 1971).

231. *See Eisenberg*, *supra* note 122, at 27-28.

232. *Aronson*, 473 A.2d at 816.

233. *See In re Emerging Comms., Inc., S’holder Litig.*, 2004 WL 1305745 at *39 & nn. 183-84 (Del. Ch.); Rhonda L. Rundle, *Kerkorian Sets up Delicate Dance at MGM*, WALL ST. J., May 23, 2007, at A2; Mirvis et al., *supra* note 146, at 6-7.

234. Jason Singer, *In Twist for Private Buyouts, Some Shareholders Fight Back*, WALL ST. J., Aug. 18, 2006, at A1; Jesse Eisinger, *Long & Short: Minority Shareholders in Sears Canada Win This Round of Ackman vs. Lampert*, WALL ST. J., Aug. 16, 2006, at C1.

235. *Aronson*, 473 A.2d at 814-15.

Every time a director does what someone else suggests without exercising independent judgment she breaches her duty. When directors act without independent judgment out of laziness, spinelessness, or psychological or structural “bias,”²³⁶ they may breach their duties of care if they are grossly negligent. However, they are usually not liable for that breach because of the business judgment rule. But when they act without independent thought because of loyalty to another, they violate the duty of loyalty and face liability if something bad can be shown to have occurred as a result of the breach. If the director’s actions do not have an effect on corporate activity, the breach will go unnoticed. But activist investors seek board seats for a reason, and they have been successful in causing changes at a number of companies in the past few years.²³⁷ If those actions are challenged, the designated directors would be subject to claims of breach of the duty of loyalty and would therefore not be protected by the business judgment rule or exculpatory clauses in the corporation’s charter.²³⁸

So how does this relate to the duty of shareholders? If a director violates a fiduciary duty because she acts out of loyalty to an individual shareholder and not to the company, the shareholder should be equally liable for complicity in the breach. This can be vicarious liability under agency principles or aiding and abetting liability. The latter treatment merely implicates the general principle that one who aids or instigates a breach of duty is also liable for the breach.²³⁹ The former treatment, however, raises another interesting problem in corporate law. Case law states expressly that directors are *not* agents of the

236. See *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938-43 (Del. 2003) (considering the subtle influences that social and professional connections can have on decision-making and the reasons therefor); *Aronson*, 473 A.2d at 815 n.8.

237. See Laura Kabler, *Money in the Game: Executing a Governance-Based Hedge Fund Strategy*, 12 STAN. J.L. BUS. & FIN. 121, 145. This is an example of a situation where a shareholder, and later director, caused a corporate action that arguably injured the Heinz Company. Under pressure from activist investor Nelson Peltz, the Heinz Board agreed to buy back \$1 billion worth of stock. As a consequence, Standard & Poors lowered the rating on Heinz’s debt to BBB+ with a negative outlook. See Serena Ng, *Corporate Debt Begins to Worry Bond Investors*, WALL ST. J., July 11, 2006, at C1.

238. Section 102(b)(7) of the Delaware General Corporation Law allows a corporation to eliminate a director’s liability for breach of fiduciary duty, but not where the breach involves a failure to act in good faith or a breach of the duty of loyalty. David M. Finz, *No Free Ride for Directors: The Delaware Exculpatory Statute and the Duty of Good Faith*, BEECHER CARLSON, (2006), <http://www.beechercarlson.com/newBeecher/WhitePapers/Delaware%20-%20No%20Free%20Ride%20for%20Directors.pdf>.

239. See *Gatz v. Ponsoldt*, 925 A.2d 1265, 1276 (Del. 2007); *In re General Motors (Hughes) S’holder Litig.*, 2005 WL 1089021 at *23 (Del. Ch. May 4, 2005); *Siegman v. Tri-Star Pictures, Inc.*, 1989 WL 48746 at *4 (Del. Ch. 1989).

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shareholders who elect them.²⁴⁰ This rule would be better phrased as, “[d]irectors had better not be agents of the shareholders who elect them, or they are in deep trouble.”²⁴¹ Agency requires that the agent be under the control of the principal.²⁴² A director who is doing her job is not under the control of anyone. That is the essence of independent judgment. Thus, when a director acts out of loyalty to another, she has not only violated her fiduciary duty, but she may have acted as an agent of the other person.²⁴³ There is no reason *automatically* to deny the existence of an agency relationship, and therefore of vicarious liability, in that situation.

VII. CONCLUSION

The law regarding corporate fiduciaries is clear: the board of directors has power over corporate assets and therefore the directors owe fiduciary duties to the corporation. Shareholders do not have such power and do not owe fiduciary duties.²⁴⁴ If, in contrast, the law bestows new powers on the shareholders as Professor Bebchuk²⁴⁵ and others would like, it must also impose duties on those shareholders. To fail to do so is not only to violate basic legal principles, but also to endanger the minority shareholders who are currently protected by the board’s fiduciary duties.

On the other hand, a corporate act²⁴⁶ undertaken on behalf of a specific shareholder (any shareholder) that injures the other

240. See Dalley, *supra* note 2, at 219.

241. See *id.*

242. Dixon v. U.S., 465 U.S. 482, 508 (1984).

243. See Zahn v. Transamerica Corp., 162 F.2d 36, 46 (3d Cir. 1947).

244. See *Susquehanna Corp. v. Korholz*, 84 F.R.D. 316, 321 (N.D. Ill. 1979). Carl Icahn’s recent involvement with Yahoo! illustrates the current the legal regime. Icahn purchased a large number of Yahoo! shares and publicly asserted that he believed the Yahoo! board, by rejecting an acquisition offer by Microsoft, had failed to act in the best interests of shareholders. See Kevin J. Delaney & Gregory Zuckerman, *Icahn Seeks to Unseat Yahoo’s Entire Board*, WALL ST. J., May 16, 2008, at B4. As a shareholder, Icahn had no power to force the Yahoo! board to do anything, even if a majority of the shareholders agreed with him. So he launched a proxy fight to gain control of the board. See *id.* In the event his slate of candidates (which includes Lucian Bebchuk) is elected, it is expected that they will pursue a transaction with Microsoft. See *id.* As directors, they will be bound by the usual fiduciary duties. Thus, the proxy fight allows the shareholders to influence corporate policy without doing violence to established legal principles and without depriving the minority shareholders of the protection provided by the board’s fiduciary duties.

245. See *generally*, Bebchuk, *supra* note 5.

246. If the act is not a corporate act, but is a shareholder act such as a shareholder selling her shares or voting in favor of a merger, no fiduciary duties apply at all, and the injured party, if there is one, is out of luck.

shareholders or the corporation itself entails a breach of fiduciary duty by the directors who so acted, and the instigating shareholder is also liable for that breach under basic agency principles. No “shareholder fiduciary duty” is implicated. Existing law, properly applied, not only addresses the problem of harmful corporate acts, but does so without doing violence to the principle that shareholders do not manage (and therefore do not owe duties to) the corporation. Suppose instead that the view that shareholders owe duties to the corporation and other shareholders becomes the legally adopted view. When is this duty implicated—when the noisy investor begins pressuring the board? When the investor votes? That is clearly within her rights as a shareholder. The only way an investor can cause harm is by controlling the board. So the law finds and punishes the breach when and where it happens – when the board members act disloyally. This analysis is not new. What is new is the number of instances of directors of publicly traded corporations, hitherto not the subject of shareholder fiduciary duty analysis, making business decisions directed by individual shareholders.²⁴⁷ The duties of those directors and the potential responsibility of the shareholders who appoint them are therefore of heightened importance.

247. See *supra* note 188 (discussing the recent, increasing trend and noteworthy examples of shareholders, usually in the form of hedge funds, asserting control over the directors in order to participate and control management decisions).