Corporate Control and the Need for Meaningful Board Accountability

Michelle M. Harner

Available at: https://works.bepress.com/michelle_harner/1/
CORPORATE CONTROL AND THE NEED FOR MEANINGFUL BOARD ACCOUNTABILITY

MICHELLE M. HARNER*

Abstract

Corporations are vulnerable to the greed, self-dealing and conflicts of those in control of the corporation. Courts historically have regulated this potential abuse by designating the board of directors and senior management as fiduciaries. In some instances, however, shareholders, creditors or others outside of corporate management may influence corporate decisions and, in the process, extract corporate value. Courts generally address this type of corporate damage in one of two ways: they designate controlling shareholders as corporate fiduciaries and they characterize creditors, customers and others as contract parties with no fiduciary duties.

The traditional roles of corporate shareholders and creditors may support the courts’ willingness to treat the former, but not the latter, as corporate fiduciaries. But shareholders and creditors no longer are necessarily acting in accordance with their traditional roles. Institutional investors, led primarily by hedge funds and private equity firms, are pursuing activist agendas as both shareholders and debt holders and frequently are successful in their efforts to influence corporate affairs. These efforts, however, may not benefit the corporation or stakeholders generally. This article explores the increasing convergence in the rights and activism of shareholders and creditors and proposes an approach for governing their conduct that focuses on the constant in corporate transactions, i.e., the board.

* Assistant Professor of Law, University of Nebraska-Lincoln College of Law. I would like to thank William Carney, James Cox, Joan MacLeod Heminway, Dennis Honabach, Colleen Medill and Fred Tung for their comments on earlier drafts of this article. I also benefited from discussions with Bernard Black, Steve Bradford and Douglas Whaley, and feedback from participants in the 2009 Association of American Law Schools Annual Meeting, Business Associations Section; the 2008 Central States Law Schools Association Conference; the 2008 Southeastern Association of Law Schools Workshop; and faculty colloquia at Emory University School of Law and the University of Nebraska-Lincoln College of Law. In addition, I appreciate the assistance of my very talented research assistants, Rebecca Holtje and John Lentz. Nevertheless, all opinions, errors and omissions in this article are my own. Finally, I thank the University of Nebraska-Lincoln College of Law for financial support.
# TABLE OF CONTENTS

I. Introduction .............................................................................. 3

II. A Need for Change .................................................................. 9

III. The Role of Corporate Stakeholders ...................................... 10
    A. Separation of Ownership and Control ............................... 10
    B. The Monitoring Role of Stakeholders ............................... 11
    C. Increasing Activism by Stakeholders ............................... 14
    D. The Potential Problems with Control and Activism .......... 16

IV. Similarities Among Corporate Stakeholders ......................... 18
    A. Common Rights Among Stakeholders .............................. 18
    B. Different Bases for Stakeholders’ Rights .......................... 21
    C. Similarities in Activist Activities .................................. 23
    D. Control Liability ............................................................ 24

V. Corporate Stakeholders and Fiduciary Duties ....................... 26
    A. Traditional Controlling Shareholder Duties ...................... 26
    B. Traditional Controlling Creditor Duties ............................ 28
    C. Challenges in the Application of Traditional Controlling
        Stakeholder Duties ........................................................... 29
        1. Controlling Stakeholders as Fiduciaries ..................... 29
        2. Uncertainty in Identifying Controlling Stakeholders ..35
    D. Expanding Fiduciary Law to Increase Stakeholder
        Accountability .................................................................. 37

VI. An Alternative to Controlling Stakeholder Duties ................. 39
    A. The Board as Fiduciary ...................................................... 39
    B. The Board’s Role in Controlled Transactions ................... 41
    C. Increasing Board Accountability in Stakeholder
        Transactions ...................................................................... 43
        1. Key Elements of the Fairness Proposal ....................... 44
        2. Consequences Under the Fairness Proposal ................. 47
        3. Advantages of the Fairness Proposal ......................... 49

VII. Potential Concerns with the Fairness Proposal ...................... 49
    A. Shareholders Should Have More Control ....................... 50
    B. Controlling Stakeholders Should Have Less Control ....... 51
    C. Independent Directors Should Not Face Increased
        Liability ........................................................................... 52
    D. The Risk of Increased Litigation .................................... 54

VIII. Conclusion ............................................................................. 54
I. Introduction

“‘Control’ cannot be prohibited by law; and perhaps it would be as well not to try. All that can be governed is the result of the controlling action.”

-Adolf A. Berle, Jr. & Gardiner C. Means.1

Corporations are at the mercy of the individuals who run them. Those individuals in turn are vulnerable to greed, self-interest and outside influence, which may lead to decisions that impair corporate value. Courts historically have used fiduciary law to curb such abuse and govern “the result of the controlling action.”

Although a variety of parties can influence corporate decisions, courts generally impose fiduciary duties only on corporate directors, senior management and certain shareholders.2 Courts are reluctant to accord similar treatment to lenders, bondholders, suppliers and other non-management parties who also can exert significant influence over a corporation. Like shareholders, these entities are not employed by the corporation, may not have the corporation’s best interests at heart and may seek to influence corporate decisions primarily to further their own economic interests.3 Nevertheless, the law treats them differently.

---

1 Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 238 (1932).
2 For ease of reference, I refer to the board of directors and senior management collectively here as either corporate management or the board. The board and senior management perform different functions for most corporations; however, these distinctions are not central to the premise of this article. In addition, I use the term “stakeholders” here broadly to mean any party with an economic interest in the corporation, including both shareholders and creditors.
3 The potential for shareholders and creditors to influence corporate management and adversely affect the rights of other corporate stakeholders is not a new phenomenon. For example, Berle and Means reference examples of controlling shareholder and creditor activity in The Modern Corporation and Private Property, and case law addressing these issues dates to the late 1800s. See Berle & Means, supra note 1, at 78–84 (discussing creditor influence over the Fox Films and Fox Theatre Corporation and shareholder influence over the Standard Oil Company); see also infra Part V. Notably, Berle and Means suggested that the dispersed-ownership corporate model may place control over the corporation in the hands of a self-perpetuating board and, as a result, substantially weaken the control of those outside of corporate management. Berle & Means, supra note 1, at 86–88, 246 (discussing control of management in dispersed-ownership model and concluding that “[i]t is conceivable, therefore, that the problems of ‘control’ [relating to majority shareholders, minority shareholders exerting influence, etc.] here discussed may become academic within another generation”). Although self-perpetuating boards have emerged, they have not eliminated control opportunities for non-management parties.
The traditional roles of corporate shareholders and creditors may support the courts’ willingness to designate the former, but not the latter, as corporate fiduciaries. Shareholders commonly are viewed as part of a corporation’s inner circle, and their rights arise in part from a state’s corporate code and related common law.\(^4\) Their stock ownership in the corporation gives them the right to, among other things, elect directors and vote on certain fundamental corporate transactions. Shareholders’ rights and insider status place them in a position to influence the decisions of corporate management. Creditors, on the other hand, are outsiders to the corporation, and their rights arise from commercial contracts with the corporation.\(^5\)

But shareholders and creditors no longer are necessarily acting in accordance with their traditional roles. Some creditors are negotiating for shareholder-like rights in their financial and other contracts with the corporation. These creditors are seeking and obtaining the right to approve or veto fundamental corporate transactions, to appoint directors or observers to the board and to retain professionals for the corporation. Moreover, these rights may be triggered or invoked by creditors at a time when the corporation is experiencing financial distress; financial leverage may give these creditors even more control than the shareholders of a solvent corporation. Consequently, any justification for distinguishing between controlling shareholders and controlling creditors in the fiduciary context may be disappearing.

Institutional investors, led primarily by hedge funds and private equity firms, are a driving force behind this emerging convergence in the roles of corporate shareholders and creditors. These institutional investors are less inclined to be passive shareholders or simple commercial creditors. They approach both equity and debt investments in a corporation as profit-generating opportunities, and they are not satisfied with market-rate returns. Accordingly, they tend to be more aggressive with their equity and debt holdings, and they often pursue the same objectives with those holdings—e.g., management turnover, changes in management compensation or shareholder dividend policies, mergers or acquisitions or even ownership control of the corporation. Regardless of their position in the

\(^4\) A corporation’s articles and by-laws often are viewed as a contract between the corporation and its shareholders. See infra Part IV.C.1.

\(^5\) See id.
corporation’s capital structure, these investors frequently are successful in their efforts to influence corporate matters.6

This article analyzes the increasing similarities between controlling shareholders and controlling creditors and what, if any, steps courts and policymakers should take “to govern the result of the controlling [stakeholder’s] action.” I use the term “controlling stakeholder” here broadly to include not only majority shareholders and debtholders but also activist minority shareholders and creditors.8

The traditional judicial response of imposing fiduciary duties on controlling shareholders is an appealing solution. A fiduciary’s primary duty in the controlled transaction context is the duty of loyalty, which prohibits or subjects to heightened scrutiny transactions involving self-dealing or conflicts of interest by the fiduciary.9 Treating all controlling stakeholders as fiduciaries thus may protect existing corporate value and non-controlling interests in the corporation.

Professors Iman Anabtawi and Lynn Stout propose extending fiduciary duties to minority shareholders who “influence[] a particular corporate action . . . in a determinative way.”10 Their proposal would expand both the traditional concept of control under controlling shareholder fiduciary law and the transactions subject to fiduciary duties. Under their proposal, “shareholder fiduciary duties [would apply] . . . to any corporate transaction or strategy that provides one or more shareholders with a material, pecuniary benefit not shared

---

6 See infra Part III.C.
7 BERLE & MEANS, supra note 1, at 238.
8 Different stakeholders can exercise varying degrees of control and influence over corporate action at different points in time. For example, an activist shareholder or debtholder may hold only a minority position but may still seek to influence the day-to-day activities of the corporation similar to the traditional majority controlling shareholder. Alternatively, they may attempt to influence a specific transaction or operational decision. See infra Part IV.
9 A corporate fiduciary owes at least two primary fiduciary duties to beneficiaries—i.e., the duty of care and the duty of loyalty. See infra Part V. In addition, some courts impose a duty of good faith as part of the duty of loyalty, rather than as an independent fiduciary duty. See, e.g., Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (“The failure to act in good faith may result in liability because the requirement to act in good faith ‘is a subsidiary element[,]’ i.e., a condition, ‘of the fundamental duty of loyalty.’”). In the context of controlling stakeholders and controlled transactions, courts tend to focus on the duty of loyalty. See infra Part V.
by other shareholders.”¹¹ This proposal could be extended to include controlling and activist creditors as well.

Invoking fiduciary law to govern the conduct of non-management parties, however, may not be a good fit. For example, is a shareholder, lender, bondholder or other investor a fiduciary? A fiduciary generally is defined as “someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.”¹² An investor typically invests in the stock or debt of a company for its own benefit and seeks to influence corporate action in a manner that furthers its self-interest. A lender or supplier typically extends credit to a corporation to generate a profit for its own business. The law certainly can try to curb a stakeholder’s self-interest by designating a controlling or activist stakeholder a fiduciary, but should it?

Likewise, does imposing fiduciary duties on stakeholders strengthen the corporation’s governance or improve long-term corporate value? Investors and other stakeholders often have short-term perspectives on their investments in or business with the corporation. They may not have the incentive or expertise to understand longer-term, value-generating opportunities for the corporation, even if they have the incentive and resources to monitor corporate performance. In contrast, the board should have the incentive and resources to identify, understand and assess both short- and long-term value-maximizing opportunities for the corporation.

For example, a debtholder may exert significant influence over a corporation that is experiencing financial distress. The debtholder may be able to dictate whether the corporation sells assets, makes distributions to shareholders or obtains additional financing. The debtholder also may effectively direct the hiring of a financial advisor or chief restructuring officer. In these and like circumstances, the debtholder arguably is exercising its contractual rights and in turn controlling corporate action in a manner that increases its potential recovery on the outstanding debt.

Rather than imposing fiduciary duties on this controlling debtholder or any stakeholder, I suggest that the board is in a better position to protect the corporation. The board can, among other things, best manage risk and decline to bend to

¹¹ Id.
a stakeholder’s potentially self-interested demands. In theory, this proposal seems simple and obvious. In practice, however, the challenge is the possibility of board passivity under the protection of the business judgment rule.\textsuperscript{13}

One potential solution is to temper the protection afforded to boards by the business judgment rule in the limited context of stakeholder cases. A decision by a board that is influenced by a stakeholder (whether or not a controlling stakeholder) could be evaluated under a standard similar to that applicable in interested director transactions.\textsuperscript{14} I refer to this new standard as the “fairness proposal.” This new standard would presume a conflict of interest for the entire board whenever it is approving a transaction out of the ordinary course of business that involves a particular stakeholder or group of stakeholders and that provides a unique benefit to those stakeholders at the expense of the corporation.\textsuperscript{15} I refer to these types of transactions as “stakeholder transactions.”\textsuperscript{16}

The fairness proposal would evaluate whether a challenged stakeholder transaction is objectively fair to the corporation. Under the proposal, the board would bear the burden of showing that a stakeholder transaction satisfies the entire fairness standard, without the presumptive protection of the business judgment rule.\textsuperscript{17} If the board fails to do so, the stakeholder transaction would be voidable and the directors would be subject to liability for breaching the duty of

\begin{itemize}
\item \textsuperscript{13} The business judgment rule may apply in a stakeholder transaction dispute where, for example, the plaintiff cannot show the requisite level of domination or control by the stakeholder. \textit{See infra} Part VI.B.
\item \textsuperscript{14} The fairness proposal suggests two notable changes to existing standards governing interested director transactions. First, most state corporate codes shift the burden of proof to the plaintiff upon a showing that, after full disclosure, the interested director transaction was approved by a majority of disinterested directors or disinterested shareholders. Second, some courts apply business judgment protection to interested director transactions if the transaction was approved by a majority of disinterested directors or shareholders. The fairness proposal does not incorporate either of these elements. \textit{See infra} Parts VI.B and VI.C.
\item \textsuperscript{15} The definition of stakeholder transaction is central to the fairness proposal and is discussed further \textit{infra} Part VI.C.1. If a plaintiff fails to show the existence of a stakeholder transaction, existing law and, potentially, the business judgment rule would govern the transaction. \textit{See id.}
\item \textsuperscript{16} As compared to existing law governing controlling shareholder transactions, the fairness proposal would not treat the alleged controlling shareholder or creditor as a fiduciary. \textit{See infra} Part VI.C.1. It also contemplates a broader definition of conflicted transactions. \textit{See infra} Part VI.C.1.
\item \textsuperscript{17} \textit{See, e.g.,} Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719–20 (Del. 1971) (“The standard of intrinsic fairness involves both a high degree of fairness and a shift in the burden of proof. Under this standard the burden is on [the controlling shareholder] to prove, subject to careful judicial scrutiny, that its transactions with [the corporation] were objectively fair.”) (citations omitted); \textit{see also infra} Part VI.B.
\end{itemize}
loyalty. Nevertheless, the fairness proposal would include procedural safeguards to protect directors from strike suits and to mitigate the potential for hindsight bias in any ultimate judicial review. For example, plaintiffs would bear the burden of production in establishing their prima facie case, and the law could impose a relatively short statute of limitations—e.g., three months after disclosure of the transaction—to foster contemporaneous review of the transaction. In addition, the board may ease its burden by exposing the stakeholder transaction to a meaningful market test.

The fairness proposal strives to achieve three primary goals. First, the proposal seeks to increase certainty in the controlled transaction context by identifying a single fiduciary and a uniform standard of review. Second, it tries to better protect corporate value by subjecting both interested shareholder and creditor transactions to review for overall fairness. Finally, it attempts to promote investor confidence without dampening investors’ incentive to do business with the corporation.

In Part II of the article, I explain the justifications for re-examining controlling stakeholder duties. I then explore the increase in stakeholder control and the similarities among controlling stakeholders in Parts III and IV. This discussion focuses on the strategies of institutional investors as both shareholders and creditors and the typical theories of liability asserted against controlling stakeholders.

In Part V, I discuss the origins of fiduciary law and the historical treatment of controlling stakeholders as corporate fiduciaries. I examine the potential conflict between a controlling stakeholder’s self-interest and the corporation’s interests and whether the fiduciary label accurately describes the relationship between a controlling stakeholder and the corporation. This analysis leads to a discussion in Part VI of the board as corporate fiduciary and a proposal for strengthening the board’s role and increasing its accountability in stakeholder transactions. Part VII further analyzes the fairness proposal set forth in Part VI and addresses some potential concerns with that proposal. Part VIII concludes by suggesting that, in most cases, controlling stakeholders should be subject to the same standard of review: a standard that allows stakeholders to act in their best interests within the bounds of the law and charges the board with protecting the best interests of the corporation.

18 See infra Part VI.C.
19 See id.
II. A Need for Change

Historically, the law has treated corporate shareholders and creditors differently.\(^{20}\) For example, directors and senior management of a solvent corporation do not owe fiduciary duties to bondholders or other creditors.\(^{21}\) They do, however, owe duties to shareholders.\(^{22}\) The different treatment accorded to shareholders and creditors frequently is justified by the contractual nature of the creditor-debtor relationship.\(^{23}\) Nevertheless, as discussed in Part IV, the line between shareholders and creditors is blurring.

Both shareholders and creditors have opportunities to exercise corporate control.\(^{24}\) Hedge funds and other institutional investors are increasingly pursuing activist agendas as shareholders and as creditors. “Since 2003, in

\(^{20}\) Courts, at times, have treated shareholders and certain creditors—primarily bondholders—in a similar manner. See Jackson v. Ludeling, 88 U.S. 616, 622 (1874) (explaining with respect to bondholders that “[w]hen two or more persons have a common interest in a security, equity will not allow one to appropriate it exclusively to himself, or to impair its worth to the others”). But see BERLE & MEANS, supra note 1, at 279 (observing that the law imposes a “sharp dividing line” between shareholders and bondholders notwithstanding the economic similarities between the two).


\(^{22}\) See, e.g., Gheewalla, 930 A.2d at 101 (“When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.”). Most courts and many commentators describe a board’s objective as “maximizing shareholder wealth.” See, e.g., Jeffrey N. Gordon, Corporations, Markets, and Courts, 91 COLUM. L. REV. 1931, 1977 (1991) (describing shareholder wealth maximization as “the bedrock of corporate law”). The Michigan Supreme Court often is credited with first articulating the standard in Dodge v. Ford Motor Co. as follows: “A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.” 170 N.W. 666, 684 (Mich. 1919). Some commentators debate that characterization of corporate purpose. See, e.g., Margaret M. Blair & Lynn A. Stout, Specific Investment: Explaining Anomalies in Corporate Law, 31 IOWA J. CORP. L. 719, 731–32 (2006) (explaining debate regarding corporate purpose as shareholder wealth maximization and arguing that “[t]here is very little in corporate law that supports it and much that cuts against it”).

\(^{23}\) See infra Part IV.C.2.

\(^{24}\) See infra Parts III.D and IV.C.
particular, the marketplace registered hundreds of instances of shareholder activism involving hedge funds; in nearly two-thirds of the cases, corporate management either immediately acquiesced in the funds’ demands or . . . agreed to major concessions to meet the activists’ expectations.”

In addition, “[h]edge funds investing in distressed debt are increasingly aiming for control of company boards, seeking more from their holdings than just yield and capital gain.”

The end result in either case is a controlling action that benefits the particular shareholder or creditor and that may or may not be fair to the corporation.

The face of “controlling” stakeholders and the nature of their controlling actions are changing. The law needs to address these changes. Professors Anabtawi and Stout have set forth one proposal in the controlling shareholder context.

I set forth an alternative proposal here. I share many of the concerns regarding activism expressed by Professors Anabtawi and Stout and others. I grant greater deference, however, to the potential benefits of both shareholder and creditor activism and propose a broader solution that focuses on the constant in corporate transactions, i.e., the board.

III. The Role of Corporate Stakeholders

A. Separation of Ownership and Control

The stock ownership of most public corporations in the United States is widely dispersed, placing control over most corporate affairs in the hands of the board of directors and senior management. State corporate codes generally provide that “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.”

The board of directors routinely delegates the day-to-day operations of the corporation to senior management. As a result, the board and senior

26 Gerard Wynn, Hedge Funds Target Distressed Companies for Control, REUTERS, Dec. 18, 2003.
27 See Anabtawi & Stout, supra note 10, at 1283–93. Many commentators express concern regarding the strategies and activism of hedge funds, which can include empty voting, short selling stock and short-termism. See infra Part VII.B.
28 See Anabtawi & Stout, supra note 10, at 1284–93 (discussing issues with conflicted activist shareholders).
29 The issues and proposal discussed in this article relate primarily to public corporations and private corporations that are not closely held. The dynamics of the typical closely-held corporation may warrant separate consideration.
30 8 DEL. C. § 141(a); see also MODEL BUS. CORP. ACT § 8.01(b).
management typically direct the business affairs of the corporation. Shareholders and other corporate stakeholders have little day-to-day input.

The interests of corporate management and corporate stakeholders do not always align. Management’s discretion over corporate affairs with minimal oversight from stakeholders presents opportunities for management to divert value from the corporation and its stakeholders. Management’s diversion of value may be intentional, to benefit management itself, or unintentional and simply the result of negligence, incompetence or apathy. In either situation, the separation of ownership from control of the corporation creates costs, commonly referred to as agency costs. Existing scholarship provides a thorough analysis of the potential implications of these agency costs.

B. The Monitoring Role of Stakeholders

Increased monitoring of corporate affairs by stakeholders—in particular, shareholders—may reduce agency costs. Active monitoring by stakeholders can encourage management to identify and pursue value-generating opportunities for the corporation and provide signals to other stakeholders and the market when management is

31 See BERLE & MEANS, supra note 1, at 121–25 (discussing the costs imposed upon the corporation by the separation of corporate control and corporate ownership); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976) (explaining economic theory of agency costs in corporate form).


acting otherwise.\textsuperscript{35} This type of monitoring by stakeholders, however, is time consuming and expensive. The average individual shareholder has neither the resources nor the incentive (based on a cost-benefit analysis) to engage in active oversight.\textsuperscript{36}

Institutional investors are in a different position than the average individual shareholder.\textsuperscript{37} These investors often have the human and financial resources to monitor corporate management and performance. Nevertheless, they may not have the incentive, or they may have potential conflicts of interest that prevent them from filling the role of corporate monitor. Most pension funds, mutual funds and insurance companies remain passive corporate investors primarily because of potential conflicts of interest arising either from fiduciary duties owed by the funds to their beneficiaries or from an existing business relationship with the corporation.\textsuperscript{38}

Hedge funds and private equity firms have the resources of other institutional investors, but do not encounter the same barriers to corporate monitoring.\textsuperscript{39} These private funds generally are not subject to the same disclosure obligations

\textsuperscript{35} See Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. Rev. 781, 842 (2001) (discussing role of monitoring in bank-centered and stock-market-centered capital markets and explaining that “[m]onitoring has two basic dimensions—monitoring insiders, to ensure that they don’t steal the company’s value from investors (shareholders or creditors), and monitoring management performance, to ensure that a company maximizes that value”); George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 Cal. L. Rev. 1073, 1078–81 (1995) (discussing signals provided to the markets and corporate stakeholders by non-equity stakeholders, including decisions by financial institutions to enter into or exit a credit facility with the corporation).

\textsuperscript{36} See, e.g., Dennis Honabach & Roger J. Dennis, The Seventh Circuit and the Market for Corporate Control, 65 Chi.-Kent. L. Rev. 681, 691 (1989) (“Direct monitoring of managerial behavior and judicial enforcement of fiduciary duties are costly and imperfect tools for reducing those costs.”) (discussing market controls as alternative to direct shareholder monitoring); Frank H. Easterbrook & Daniel R. Fischel, Limited Liability and the Corporation, 52 U. Chi. L. Rev. 89, 95 (1985) (discussing costs of monitoring and impediments to monitoring by individual shareholders).

\textsuperscript{37} See, e.g., Black, supra note 34, at 831–39 (explaining the potential of institutional investors to be effective corporate monitors).

\textsuperscript{38} See, e.g., id. (discussing impediments to institutional investor activism and monitoring, including potential conflicts of interest); see also Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 523, 600 (1990).

and regulatory oversight imposed on traditional institutional investors. Moreover, the general purpose of these private funds is to provide significant returns to investors in a relatively short period of time. Investors are attracted to private funds because these funds claim to outperform traditional public markets. Investors also pay significant management fees to the private funds to achieve these results.

The profit expectation associated with private funds and the funds’ fee structures provide incentive for private funds to be more than passive investors. Private funds are more willing than traditional institutional investors to take aggressive positions with management. As shareholders, private funds pursue changes in, among other things, corporate management, management compensation packages and operational strategies. They may even seek a controlling ownership interest in, and representation on the board of, the corporation. As debtholders, private funds pursue similar objectives, although the target of their efforts typically is the financially distressed corporation.

The private funds’ desire to achieve significant profits on a relatively short investment horizon raises concerns regarding their impact on long-term corporate value. For

41 See, e.g., Bratton, supra note 40, at 1383 (“The tie that binds the hedge funds together, despite the variety of investment styles, is their promise to deliver above-market returns, a task that becomes harder and harder as more funds pursue the same strategies.”).
42 See, e.g., Jonathan Klick & Robert H. Sitkoff, Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey’s Kiss-Off, 108 COLUM. L. REV. 749, 828 (2008) (“Unlike mutual fund and pension fund managers, who receive management fees on the order of 0.5% to 3%, hedge fund managers receive performance rewards in the neighborhood of an additional 15%.”); see also Illig, supra note 32, at 282–87 (discussing fee structures of private funds and the correlation between fees and activism).
43 See Kahan & Rock, supra note 40, at 1029 (“This activism takes a variety of forms, from public pressure on a portfolio company to change its business strategy, to the running of a proxy contest to gain seats on the board of directors, to litigation against present or former managers.”).
45 See Kahan & Rock, supra note 40, at 1087–91 (observing that “[s]hort-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism” and positing potential responses to this critique of private fund activism);
that reason, many commentators view activism by private funds negatively and do not believe that these funds are appropriate corporate monitors.\textsuperscript{46} I suggest that caution is warranted when evaluating the role of private funds in corporate governance. Nevertheless, I also suggest that they and similar investors have a productive role to play. As discussed further below, activist stakeholders challenging the conduct of \textit{strong} management may enhance overall corporate performance.\textsuperscript{47}

C. Increasing Activism by Stakeholders

Private funds and some traditional institutional investors are increasingly taking a more active role in corporate governance.\textsuperscript{48} Private funds are more vocal in the proxy process, seeking a broad range of reforms from the corporation’s capital structure to corporate governance matters.\textsuperscript{49} They also use shareholder proposals and informal meetings with management to pursue their agendas. Institutional investors have been relatively successful in facilitating corporate change through shareholder activism.\textsuperscript{50}

\begin{flushright}
\end{flushright}

\begin{flushright}
\end{flushright}

\begin{flushright}
\textsuperscript{47} I emphasize the need for strong management in this model because management must have the fortitude to evaluate objectively the proposals and pressures advanced by institutional investors. \textit{See} Klick & Sitkoff, \textit{supra} note 42, at 826 (2008) (noting, in context of study suggesting that market controls are more effective monitors than controlling shareholders, that “a controlling shareholder, at least one whose agents are poorly motivated, provides less discipline against corporate agency costs than the takeover market”); \textit{see also infra} Part VI.
\end{flushright}

\begin{flushright}
\textsuperscript{48} \textit{See} Klick & Sitkoff, \textit{supra} note 42, at 826 (“The incidence of controlling shareholders and minority blockholders is increasing among public U.S. firms and is even more common among public companies in Europe.”).
\end{flushright}

\begin{flushright}
\textsuperscript{49} \textit{Hedge Fund Activism}, \textit{supra} note 25, at 27 (listing demands typically made by activist private funds, including expanding share repurchase program, declaring special dividends, asset sales and mergers, declassifying the board and repealing shareholder rights plans and other anti-takeover measures).
\end{flushright}

\begin{flushright}
\textsuperscript{50} \textit{Id.} at 32 (“In nearly two-thirds of the cases analyzed for the 2001–2006 period, corporate management either immediately acquiesced in the funds’ demands or, after a phase of initial resistance and negotiation, agreed to major concessions to meet activists’ expectations.”); Alon Brav et al., \textit{Hedge Fund Activism, Corporate Governance and Firm Performance}, 63 \textit{J. OF FIN.} 14 (2008) (providing empirical data supporting findings of activism and success rates in \textit{Hedge Fund Activism}); \textit{see also} Braiton, \textit{supra} note 40, at 1407–10 (“The activists have an impressive record of success in the cases in the sample—so impressive that the record supports the
Examples of effective shareholder activism include proxy fights and publicity campaigns against Applebee’s International, Inc., General Motors Corporation, H.J. Heinz Company, McDonald’s Corporation, Time Warner Inc. and Wendy’s International, Inc.51

Institutional investors’ activism as debtholders also is on the rise.52 Investors can exert influence over the corporation in negotiating or renegotiating the covenants of the underlying debt instrument.53 They can demand concessions or tighter covenants in response to a corporation’s potential default under existing debt instruments. They can purchase a distressed corporation’s existing debt and attempt to control the corporation’s financial restructuring or bankruptcy.54 Investors frequently invoke a combination of the foregoing strategies.

As in cases involving shareholder activism, institutional investors also are achieving their goals as activist debtholders.55 Activist debtholders are changing management, suggesting asset sales, encouraging distressed corporations to retain restructuring professionals and pursuing debt-for-equity exchanges that provide the debtholder with a meaningful, or perhaps controlling, ownership interest in the restructured corporation. Activist debtholders pursued one or more of these objectives in the restructurings of, for example, Allied Holdings, Inc., Bally’s Total Fitness, Inc., Granite Broadcasting, Inc., Kmart Corporation, Radnor Holding Corp. and Werner Co.56

proposition that they have shifted the balance of corporate power in the direction of outside shareholders and their financial agendas.”). 51 Hedge Fund Activism, supra note 25, at 34–37 (listing tactics used by funds and outcome of activism at these and other corporate targets); see also Kahan & Rock, supra note 40, at 1030–35 (discussing activism at high-profile companies).


54 See, e.g., Hotchkiss & Mooradian, supra note 44 (empirical study of 288 firms finding that “[v]ultures join the board of directors of 80 firms (27.8% of the sample). . . . become CEO or Chairman of 27 firms (9.4%) and gain control of 47 firms (16.3%), often through the purchase of senior claims such as bank loans.”).


The increase in stakeholder activism raises questions about who is or should be controlling the corporate entity. The presence of a controlling stakeholder potentially shifts the balance of power. If management cedes to the demands of the controlling stakeholder, regardless of whether those demands further the interests of the corporation, control of the corporation may benefit one stakeholder or a small group of stakeholders at the expense of others.

D. The Potential Problems with Control and Activism

Stakeholder control can take any number of forms; it can be subtle or overt, direct or indirect. Regardless of its form, stakeholder control may mask self-dealing or a conflict of interest that ultimately impairs corporate value. Consider the following examples:

The story of the Mylan Labs/King Pharmaceuticals merger is well known primarily for the empty voting strategy invoked by Perry Capital. This story also illustrates, however, the potential influence of shareholders who do not own a majority of the company’s stock and are not necessarily seeking a direct transaction with the company. Perry Capital and other King shareholders purchased Mylan stock and publicly supported the merger. Carl Icahn, on the other hand, was long on Mylan stock and short on King stock and publicly opposed the merger, even making a bid for Mylan. All of these shareholders were trying to influence the Mylan board to pursue the transaction that benefited their individual economic interests, regardless of


what that decision meant for the corporation and other shareholders.

When a corporation experiences financial distress, shareholders may try to encourage the corporation to buy back their stock or influence restructuring decisions. First Reserve Corp. pursued the former strategy with respect to its investment in James River Coal Co., and preferred stockholders, led by Harbinger Capital Partners Master Fund Ltd., pursued the latter strategy with respect to their investment in Granite Broadcasting Corp. In these and similar instances, shareholders may try to steer the corporation in a direction that salvages their existing investment in the corporation or, perhaps, benefits their other holdings in the corporation itself or other portfolio companies.

Moreover, creditors may try to exploit a corporation’s financial distress to receive fees, payments and other benefits not included in their original contracts. For example, in Granite Broadcasting, the majority noteholder, Silver Point Capital Finance, LLC, negotiated interim and postpetition financing for the corporation that yielded, among other things, significant fees and greater collateral rights. In addition, in connection with this financing, Silver Point obtained a majority ownership position in the reorganized company. Other creditors used similar strategies to receive large refinancing payments and gain post-reorganization control in the Radnor Holding Corp. and Werner Co. chapter 11 cases, among others. A creditor-motivated transaction may not align with the board’s duty to implement a strategy that is in the corporation’s best interests and that maximizes shareholder or creditor wealth, depending on the corporation’s solvency.

---


61 Empty voting (i.e., the strategy of buying the voting, but not economic, rights associated with stock), shorting stock and distressed arbitrage are a few examples of private fund investment strategies that can benefit the fund at the expense of the target corporation. “Distressed arbitrage [generally] involves purchasing publicly traded bonds of bankrupt companies and selling their common stock short.” Donna Klinger, Here Be Dragons, NACUBO BUS. OFFICER, Apr. 2002, at 33. For a general description of hedge fund investment strategies, see JESS LEBERMAN & ROBERT A. KLEIN, HEDGE FUNDS (1995).


IV. Similarities Among Corporate Stakeholders

Although differences remain between corporate shareholders and creditors, the two play very similar roles in the controlled transaction context. Either a shareholder or a creditor negotiating a transaction with, or seeking to influence a transaction by, the corporation uses its investment in the corporation as leverage and generally pursues its own self-interest in the transaction. For these and related reasons discussed below, the fairness proposal is not dependent on the controlling stakeholder’s position in the corporation’s capital structure.

A. Common Rights Among Stakeholders

The basic rights of shareholders include the right to elect directors, vote on certain fundamental corporate matters, receive dividends and sell their stock. The right to elect directors and vote on fundamental transactions commonly serves as a basis for shareholder control. Shareholders owning or having influence over a majority of a corporation’s voting stock can determine the composition of the board and whether key transactions are pursued. Shareholders owning less than a majority may still influence these matters if they control a sufficient amount of stock to elect at least one director or block the approval of key transactions.

The basic rights of creditors vary depending on the terms of their contracts with the corporation. These contracts, however, can and often do grant creditors the right to veto

---


66 Id.


68 See, e.g., Williamson v. Cox Commc’n, Inc., No. 1663-N, 2006 Del. Ch. LEXIS 111, at *4–*10 (Del. Ch. June 5, 2006) (minority shareholders who had right to designate one director each and significant commercial contracts with corporation were potentially liable as controlling shareholders); In re Cysive, Inc., S’holder Litig., 836 A.2d 531, 552 (Del. Ch. 2003) (“In practical terms, Carbonell holds a large enough block [approximately 40%] of stock to be the dominant force in any contested Cysive election.”); Kahn v. Lynch Commc’n Sys., 638 A.2d 1110 (Del. 1994) (43.3% minority shareholder determined to be controlling shareholder); see also Rosener v. Majestic Management, Inc. (In re OODC, LLC), 321 B.R. 128, 142 (Bankr. D. Del. 2005) (connections between alleged control person and board may be sufficient to impose fiduciary duties solely on that basis).
fundamental corporate transactions, receive financial information, observe board meetings and appoint one or more directors or convert the debt into equity under certain circumstances. In addition, the default, acceleration and remedy provisions of these contracts may permit the creditor to foreclose on the corporation’s assets or exert substantial influence over the corporation in the context of a forbearance agreement.

A shareholder’s or creditor’s relationship with the corporation may provide it with leverage in the parties’ negotiations. In general, the exercise of contractual rights granted by the corporation to a shareholder or creditor will not constitute the degree of control necessary for controlling stakeholder duties. A plaintiff may, however, use contract terms as evidence of excessive control by the shareholder or creditor over the corporation and its affairs.

---

69 See, e.g., Baird & Rasmussen, supra note 53, at 1236–42 (describing mechanics and use of debt covenants in context of debtor-in-possession loans); Kuney, supra note 53, at 46–74 (same). Loan covenants may give lenders the ability to approve changes to management or board personnel or require the corporation to hire a chief restructuring officer or similar executive. See, e.g., Baird & Rasmussen, supra note 53, at 1233 (explaining increasing use of chief restructuring officers and noting that “[a] change in managers or directors without the banks’ explicit blessing is often an event of default under the loan covenants”); Susan Diesenhouse, Kimball Hill Sets Job Cuts, Pullback: Home Builder Hopes to Avert Bankruptcy, CHIC. TRIB., Feb. 28, 2008 (noting that the company “amended some agreements with its lenders in order to return to compliance with loan covenants and hired a restructuring officer”); Rick Daysog, Aloha Will Hire New Restructurer, THE HONOLULU ADVERTISER, Sept. 20, 2005 (“Paul Singerman, Aloha’s attorney, said in court papers that its lenders Abelco Finance LLC and Goldman Sachs Credit Partners LP have pushed for the hiring of a chief restructuring officer in exchange for continued funding.”). In addition, lenders may obtain the explicit right to appoint directors either in connection with a small equity investment, typically in the form of preferred stock, or upon the corporation’s failure to obtain certain financial or performance targets. See, e.g., In re Radnor Holdings Corp., 353 B.R. 820, 829–30 (Bankr. D. Del. 2006) (private equity firm purchased preferred stock and made substantial secured loan to corporation and received, among other consideration, warrants and right to appoint one director and one observer to board); PCG Capital Partners Invests in Specialty Paper and Tissue Company, BUSINESS WIRE, Aug. 26, 2005 (private equity firm invested $35 million in subordinated notes and equity and received, among other consideration, the right to appoint two directors to corporation’s board). Creditors also may obtain the right to appoint one or more of a reorganized corporation’s directors in connection with a debt-for-equity exchange or similar restructuring. See, e.g., In re Granite Broad. Corp., 369 B.R. 120, 125 (Bankr. S.D.N.Y. 2007) (explaining that “Silver Point [the debtors’ prepetition lender] will also be able to appoint six of seven directors of the reorganized Debtors”).


71 The trustee in the Del-Met bankruptcy case alleged that certain creditors’ pre-existing relationships with Del-Met allowed them to negotiate and maintain below market contracts to their significant benefit. See Limor v. Buerger (In re Del-Met Corp.), 322 B.R. 781 (Bankr. M.D. Tenn. 2005). The court in the At Home Corporation bondholder litigation opined that alleged leverage by shareholders over commercial contract negotiations with the corporation may
rights in a contract may contribute to a finding that an entity was a controlling shareholder, and such rights constitute another factor that should be considered in determining whether defendants had actual control over a company.”

Like shareholders, creditors also have economic rights with respect to their corporate debtors. The corporation must repay the loan amount or pay for the services or goods provided under the parties’ contracts. Moreover, the corporation may be obligated under the applicable agreements to pay interest on the loan amounts, as well as fees and costs. Many creditors also have the ability to sell their debt contracts with the corporate debtor. Active markets exist for secured debt, bonds and even trade debt, particularly when the corporation experiences financial distress.

In some instances, creditors may possess more rights than shareholders with respect to the corporation, including more control rights. A creditor’s control and opportunities for control increase as a corporation’s financial situation deteriorates. A potential default under a loan agreement or


72 Nisselson, 361 B.R. at 391.

73 Some commentators have acknowledged the economic similarities between shareholders and bondholders. See supra Part II; see also BERLE & MEANS, supra note 1, at 279–80 (noting that shareholders and bondholders “may be regarded as a hierarchy of individuals all of whom have supplied capital to the enterprise, and all of whom expect a return from it”).

74 See, e.g., Kuney, supra note 53, at 56–57 (discussing pricing and fees in debtor-in-possession loans); see also James J. White, Death and Resurrection of Secured Credit, 12 AM. BANKR. INST. L. REV. 139 (2004) (describing fees and costs generally associated with secured credit).


76 See Silver Point Finance’s (i) Response to Certain Objections to confirmation of Debtors’ Plan of Reorganization and (ii) Joinder in (a) Creditors’ Committee’s Objection to Claims of Bartholomew Palmisano, Jr. and (b) Creditors’ Committee’s Motion to Designate Palmisano’s Vote, In re OCA, Inc., No. 06-10179(B) (Bankr. E.D. La. Sept. 1, 2006) [Silver Point Response] (explaining role of controlling shareholder and director in corporation prior to bankruptcy and referencing creditor’s ability to encourage his resignation and to obtain a controlling ownership interest in the reorganized corporation); see also Limor v. Buerger (In re Del-Met Corp.), 322 B.R. 781 (Bankr. M.D. Tenn., 2005) (explaining significant leverage obtained by the debtor’s customers through prepetition commercial and financing contracts); Baird & Rasmussen, supra note 53 (“These loan agreements define defaults in ways that give creditors as much control over the board and its decisions as shareholders. Indeed, in the limit, these covenants can obliterate the difference between debt and equity.”).
major supply contract can have a devastating and rippling effect on a corporation’s business. A creditor may hold substantial leverage in negotiations with a corporation under these circumstances.\textsuperscript{77}

B. Different Bases for Stakeholders’ Rights

Both shareholders and creditors are viewed as having a contractual relationship with the corporation.\textsuperscript{78} The shareholders’ contract is based on applicable state law and the corporation’s articles of incorporation.\textsuperscript{79} This basic contract may be supplemented by individual agreements between the corporation and other shareholders. As suggested above, the creditors’ contract depends on the nature of the relationship between the corporation and the creditor and largely is the product of negotiation between the parties.

The statutory basis of the shareholder contract leaves it incomplete in many respects. These gaps are filled by common law, including fiduciary duty law.\textsuperscript{80} In the context

\textsuperscript{77} Accordingly, creditors negotiating a forbearance or restructuring agreement with a corporation frequently request and obtain control covenants similar to the following:

7.16 Financial Advisors. The Borrower shall employ and maintain the services of a financial adviser acceptable to the Lenders . . . .

7.17 Management. The Borrower shall employ and maintain such employment of an individual or individuals acceptable to the Lenders to the positions of Executive Vice President and Chief Administrator Officer . . . .

8.4 Disposition of Assets. [Subject to certain exceptions, each] of the Credit Parties will not, and will not permit or cause any of its Subsidiaries to sell, assign, lease, convey, transfer or otherwise dispose of . . . all or any portion of its assets, businesses or properties . . . .

Silver Point Response, \textit{supra} note 76, at Exhibit F (Sixth Amendment to Credit Agreement).

\textsuperscript{78} See, e.g., \textit{Berle & Means}, \textit{supra} note 1, at 280 (explaining contractual relationship between corporation and bondholders, corporation and preferred stock owner and corporation and common stock owners); see also Lawrence E. Mitchell, \textit{The Fairness Rights of Corporate Bondholders}, 65 N.Y.U. L. Rev. 1165, 1186-87 (1990) (“The principal distinction between these contributors of capital that has led to limiting bondholders’ rights to those specified in their contract (in contrast to treating stockholders as beneficiaries of fiduciary duties) is that bondholders are creditors outside the statutory structure of the corporation, whose contract is specific, written, and negotiated; by contrast, stockholders are the owners of the corporation (after satisfaction of its liabilities), whose ‘contract’ consists of a generalized corporate charter and by-laws and is otherwise largely indeterminate.”).


of the controlling shareholder, fiduciary duty law can be viewed as protecting minority holders who cannot contract for their own protection.81

The genesis of the creditor contract is notably different. In most instances, the key terms of the contract, including the respective rights of the parties upon default, are specifically negotiated by the parties.82 The corporation and the creditor are presumed to be sophisticated business entities capable of protecting their interests in the negotiation and ultimate terms of the contract. Courts will enforce the parties’ contract but will rarely rewrite or supplement the contract terms.83

The different degrees of contractual leverage and protection afforded shareholders versus creditors may justify treating the control rights and duties of these stakeholders differently.84 Nevertheless, the increasing use of control covenants and hybrid financial instruments, activism by shareholders and creditors, and liquidity in both the equity and debt markets may lessen the practical importance of any contractual differences.85

82 But see Mitchell, supra note 78, at 1179 (explaining that bondholders typically do not participate in the negotiation of the bond contract).
83 See, e.g., Ernie Haire Ford, Inc. v. Ford Motor Co., 260 F.3d 1285, 1290–91 (11th Cir. 2001) (“[I]t is well settled that ‘when the terms of a voluntary contract are clear and unambiguous, . . . the contracting parties are bound by those terms, and a court is powerless to rewrite the contract to make it more reasonable or advantageous for one of the contracting parties.’”) (citations omitted); Cruden v. Bank of New York, 957 F.2d 961, 976 (2d Cir. 1992) (“[A] court may neither rewrite, under the guise of interpretation, a term of the contract when the term is clear and unambiguous, nor redraw a contract to accord with its instinct for the dispensation of equity upon the facts of a given case.”) (citations omitted).
84 See, e.g., Velasco, supra note 65, at 443 (“The difference is in the terms of their contracts: where the shareholder has the right to all the residual profits of the business, if any, the bondholder has the right to receive a specified return, and no more.”). At least one commentator has suggested subjecting both shareholders and creditors to fiduciary duties under the standards applicable to controlling shareholders. See Jeffrey John Haas, Insights into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders, 135 U. PA. L. REV. 1321 (1987).
85 Commentators evaluating corporate models other than the shareholder-primacy model often acknowledge the similar circumstances of shareholders and creditors. See, e.g., Lynn A. Stout, The Mythical Benefits of Shareholder Control, 93 V.A. L. REV. 789, 804–05 (2007) (discussing team production model of corporate governance and noting that “while shareholders may share in the wealth when the corporation does well and suffer when the firm does poorly, so may employees, creditors, and other stakeholders”); Theresa A. Gabaldon, Like a Fish Needs a Bicycle: Public Corporations and Their Shareholders, 65 Md. L. REV. 538, 542 (2006) (explaining that, under options theory, “once a firm has issued debt, debtholders and holders of equity both share contingent control and bear residual risk”); Mitchell, supra note 78, at 1171–77 (discussing roles of
C. Similarities in Activist Activities

The rights held by shareholders and some creditors allow activist investors to pursue their agendas as shareholders, creditors or both. Activist shareholders and activist creditors may try to influence the composition of the board, the sale of assets, a takeover of the corporation or other significant transaction. 86

For example, shareholders of Yahoo Inc. began campaigning for a new CEO and board prior to the company’s 2008 annual meeting. 87 Shareholders led by activist investor Carl Icahn reportedly were upset over the Yahoo board’s handling of a proposed bid for the company by Microsoft Corp. 88 In the months leading up to the annual meeting, several of Yahoo’s top executives resigned and Yahoo announced a significant strategic and operational restructuring.

Similarly, senior lenders led by Silver Point Capital and bondholders of Tropicana Entertainment Holdings LLC lobbied the bankruptcy court presiding over Tropicana’s reorganization to remove its CEO from “all management and directorial decisions.” 89 Tropicana’s CEO voluntarily resigned his position but retained his equity position in the company. Tropicana also appointed a new CEO and five-member board. 90 These changes, however, did not satisfy Tropicana’s bondholders, who continued to pursue the appointment of a trustee for the company.

In both cases, stakeholders influenced key decisions by boards. The management changes at Yahoo and Tropicana ultimately may serve the interests of the corporations and their stakeholders. The results largely will depend on future board decisions regarding operations and, in Tropicana’s case, its capital structure. Activist stakeholders also may influence other types of board decisions, including proposed mergers, asset sales or recapitalizations. 91 These types of decisions have a more immediate impact on corporate

shareholder and bondholders and corresponding management fiduciary duties); see also BERLE & MEANS, supra note 1, at 120 (“When speaking of the ownership of all corporations, the bondholders are often included with the stockholders as part owners.”).

86 See supra Part III.C.
87 Executive Shakeup Reported at Yahoo, CNN.MONEY.COM, June 19, 2008.
88 Id.
90 Id.
91 See supra Part III.C.
interests and, consequently, may trigger disagreements among the stakeholders themselves.\textsuperscript{92}

D. Control Liability

The identity and motivations of an alleged controlling stakeholder are relevant to an analysis of existing law. A controlling shareholder generally is defined as one who “exercises a controlling influence over the management or policies of the corporation or the transaction or conduct in question by virtue of the person’s position as a shareholder.”\textsuperscript{93} A controlling shareholder also includes any person or entity that owns a majority of the corporation’s stock.\textsuperscript{94} A controlling creditor generally is defined as one who “exercises unreasonable or excessive control over its borrower” or customer.\textsuperscript{95}

A shareholder or creditor exercising excessive control over corporate affairs may be subject to liability for breaching a fiduciary duty to the corporation and its stakeholders.\textsuperscript{96} Non-controlling stakeholders, either in a direct or derivative capacity, are not hesitant to assert breach of fiduciary duty claims against alleged controlling stakeholders. This type of fiduciary litigation commonly includes claims for aiding and abetting breaches of fiduciary duty and breaches of fiduciary duty by at least certain board members with ties to the alleged controlling stakeholder.\textsuperscript{97} It also may include claims for fraud, misrepresentation, alter ego, equitable subordination, unjust enrichment or deepening insolvency, among others.\textsuperscript{98}

\textsuperscript{92} See generally Kurt F. Gwynne, Intra-Creditor Committee Conflicts, Multiple Creditors’ Committees, Altering Committee Membership and Other Alternatives for Ensuring Adequate Representation Under Section 1102 of the Bankruptcy Code, 14 AM. BANKR. INST. L. REV. 109 (2006) (discussing potential conflicts among committee members and their impact on chapter 11 cases).

\textsuperscript{93} PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.10(a)(2) (American Law Institute 2008).

\textsuperscript{94} Id. at § 1.10(a)(1).


\textsuperscript{96} See infra Part V.


\textsuperscript{98} See supra note 97.
Controlling stakeholders may face litigation for their conduct, but court-imposed fiduciary liability is rare. Some courts are reluctant to impede the immunity granted to shareholders under state common law and statutory law.\textsuperscript{99} Even courts that are inclined to impose fiduciary duties on a controlling stakeholder generally set a high bar for plaintiffs, particularly in the non-shareholder context.\textsuperscript{100} No state imposes fiduciary duties on non-controlling stakeholders. Many controlling stakeholder cases are dismissed or settled prior to trial.\textsuperscript{101}

Consequently, a cost-benefit analysis may explain, in part, why stakeholders continue to pursue and exert control over corporate affairs. The objective of the controlled conduct typically benefits the controlling stakeholder either exclusively or on a pro rata basis with other stakeholders.\textsuperscript{102} Moreover, where the benefit is exclusive, the controlling stakeholder’s risk of liability is low. Controlled transactions typically are good business for the controlling stakeholder.

Controlled transactions may or may not be good business, however, for the corporation. Controlled transactions are

\textsuperscript{99} See \textit{Schnelling}, 360 B.R. at 174 (requiring plaintiff to show elements sufficient to pierce the corporate veil in order to impose liability against controlling shareholder and noting that “'[a] refusal to recognize the ordinary immunity of stockholders is not only overturning a basic provision of statutory or common law, but is also contrary to a vital economic policy underlying the whole corporate concept’”) (citations omitted). This general concern also underlies the principle that minority shareholders, absent control, owe no duties to the corporation. \textit{See}, e.g., \textit{US Airways Group v. British Airways PLC}, 989 F. Supp. 482, 494 (S.D.N.Y. 1997) (opining that a claim of vicarious liability against a minority holder “would completely undermine Delaware corporate law, which limits such fiduciary duty to majority and controlling shareholders”).

\textsuperscript{100} See infra Parts V.A and V.B; see also \textit{Pentech Pharms., Inc. v. Par Pharm., Inc.}, No. 04 C 3149, 2004 U.S. Dist. LEXIS 21173, at *8 (N.D. Ill. Oct. 20, 2004) (“Generally, New York courts are loath to recognize the existence of a fiduciary relationship between contracting sophisticated parties to a business transaction where the relationship is not created explicitly in a contract.”) (citing cases interpreting New York law); \textit{Price v. Wells Fargo Bank}, 213 Cal. App. 3d 465, 475–76 (Ct. App. 1989) (noting that “[a] debt is not a trust and there is not a fiduciary relation between debtor and creditor as such”).

\textsuperscript{101} A controlling stakeholder case may be dismissed early in the litigation if the plaintiff cannot establish the requisite control and the business judgment rule applies. \textit{See}, e.g., \textit{Stanziale v. Nachtomi (In re Tower Air, Inc.)}, 416 F.3d 229, 235 (3d Cir. 2005) (granting motion to dismiss where plaintiffs failed to allege sufficiently directors’ self-interest or ties to controlling shareholder); \textit{In re Tyson Foods, Inc. Consol. S’holder Litig.}, 919 A.2d 563, 588 (Del. Ch. 2007) (same). Alternatively, if the entire fairness standard applies and the case survives a motion to dismiss, the case likely will settle prior to trial. \textit{See} A.C. Pritchard, \textit{Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price}, 1 BERKELEY BUS. L.J. 83, 89 (2004) (explaining that, in the controlling shareholder context, “[a] claim that can withstand a motion to dismiss may have settlement value, if only to avoid the expense of discovery.”).

\textsuperscript{102} See \textit{supra} Part III.C.
often abusive; the corporation and non-controlling stakeholders may be injured in the process. For these reasons, some regulation of controlled transactions is necessary. The remainder of this article analyzes potential solutions to control issues, including increased controlling stakeholder duties and stricter board accountability.

V. Corporate Stakeholders and Fiduciary Duties

The foundation of controlling stakeholder duties is fiduciary law.\(^\text{103}\) Existing law designates certain controlling stakeholders as corporate fiduciaries. As such, these stakeholders owe a duty of undivided loyalty to the corporation and, in some instances, minority holders.\(^\text{104}\)

The fiduciary label, however, is inapt. Modern corporate investment practices do not contemplate or create a trust relationship among investors.\(^\text{105}\) Principles of limited liability and contract rights conflict with fiduciary notions, which may explain the stringent evidentiary bar employed by courts in the controlling creditor context.\(^\text{106}\) As a result, the imposition of controlling stakeholder fiduciary duty is an uncertain and, at times, an underinclusive remedy to address potential abuse in controlled transactions.\(^\text{107}\)

A. Traditional Controlling Shareholder Duties

In general, shareholders do not owe a fiduciary duty to the corporation, its shareholders or its other stakeholders.\(^\text{108}\) "Moreover, it is well established law that nothing precludes . . . a stockholder from acting in its own self-interest."\(^\text{109}\)

These general principles do not apply, however, if the shareholder owns a majority of the corporation’s stock or

---


\(^{104}\) Some courts suggest that controlling shareholders owe their primary fiduciary duty to other shareholders. See, e.g., Bangor Punta Operations, Inc. v. Bangor & A. R. Co., 417 U.S. 703, 716 (1974) ("It is settled law that the fiduciary duty owed by a controlling shareholder extends primarily to those who have a tangible interest in the corporation."); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971) ("The controlling stockholder owes the corporation a fiduciary obligation—one ‘designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.’") (quoting Pepper, 308 U.S. 295 at 307).

\(^{105}\) See infra Part V.C.

\(^{106}\) See infra Part V.C.

\(^{107}\) Controlling stakeholder fiduciary duty also could be overinclusive to the extent that majority ownership or pursing self-interest alone is sufficient to impose duties on a stakeholder. See infra Part V.C.

\(^{108}\) See, e.g., Gradient OC Master, Ltd. v. NBC Universal, Inc., 930 A.2d 104, 130 (Del.Ch. 2007).

exercises actual control over corporate affairs.\textsuperscript{110} A majority or controlling shareholder owes a fiduciary duty to the corporation and its minority shareholders.\textsuperscript{111} Although some courts suggest that a controlling shareholder owes both a duty of care and a duty of loyalty,\textsuperscript{112} the majority hold that controlling shareholder duties fall within the duty of loyalty. The duty of loyalty requires only that the controlling shareholder act fairly towards the corporation and minority shareholders. “[I]t does not, absent a showing of culpability, require that directors or controlling shareholders sacrifice their own financial interest in the enterprise for the sake of the corporation or its minority shareholders.”\textsuperscript{113}

The notion of a controlling shareholder’s fiduciary duties dates to the nineteenth century and is based on the exercise of control over common property owned jointly by the controlling shareholder and the minority or non-controlling shareholders.\textsuperscript{114} “It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation.”\textsuperscript{115} The United States Supreme Court has described the powers of controlling shareholders as “powers in trust.”\textsuperscript{116}

\textsuperscript{110} See, e.g., Gradient OC Master, 930 A.2d at 130; see also \textit{Principles of Corporate Governance}, supra note 93, at \S\ 1.10(a); Ronald J. Gilson & Jeffrey N. Gordon, \textit{Controlling Controlling Shareholders}, 152 U. PA. L. REV. 785 (2003) (summarizing and analyzing existing controlling shareholder fiduciary duty law).

\textsuperscript{111} See, e.g., Wheeler v. Abilene Nat'l Bank Bldg. Co., 159 F. 391, 393 (8th Cir. 1908) (“The holder of the majority of the stock of a corporation has the power, by the election of biddable directors and by the vote of his stock, to do everything that the corporation can do . . . . This devolution of unlimited power imposes on a single holder of the majority of the stock a correlative duty, the duty of a fiduciary or agent, to the holders of the minority of the stock . . . .”); Anabtawi & Stout, supra note 10, at 1269 (observing that “because shareholders generally elect and remove directors by majority vote, a shareholder who owns more than 50% of the company's outstanding shares has become the archetypal ‘controlling’ shareholder”).

\textsuperscript{112} See, e.g., Cinerama, Inc. v. Technicolor, Inc., 1991 Del. Ch. LEXIS 105, at *19 (Del Ch. June 24, 1991), aff'd in part, rev'd on other grounds sub nom. (“[W]hen a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of a corporation.”).

\textsuperscript{113} Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 598 (Del. Ch. 1986).

\textsuperscript{114} See, e.g., Menier v. Hooper's Telegraph Works, (1874) 9 Ch. App. 350, 354-355 (U.K.) (frequently cited case from the United Kingdom holding that the majority cannot profit at the expense of the minority); see also Jones v. Missouri-Edison Electric Co., 144 F. 765, 770 (8th Cir. 1906) (holding that although a shareholder's duties generally are contractual, shareholders have a joint interest in the same property and must not do anything to impair title to that property).


Notwithstanding the breadth suggested by the trust analogy, courts generally exercise restraint in imposing fiduciary duties on controlling shareholders. As discussed above, courts require a plaintiff to allege majority ownership or “domination by a minority shareholder through actual control of corporation conduct.” Courts also tend to limit controlling shareholders’ fiduciary duties to certain transactions, primarily minority freeze-out transactions and transactions in closely held corporations. Consequently, a controlling shareholder’s risk of facing actual liability for a breach of fiduciary duties is relatively low.

B. Traditional Controlling Creditor Duties

Like shareholders, creditors generally do not owe any fiduciary duties to their corporate debtors or the debtors’ other stakeholders. This default rule is based on the contractual nature of the creditor-debtor relationship. The rule extends to situations where the creditor also may hold an equity interest in the corporate debtor. “[O]ne who may be both a creditor and a fiduciary (e.g., a director or controlling shareholder) does not by reason of that status alone have special limitations imposed upon the exercise of his or her creditor rights.”

A creditor nonetheless may assume a fiduciary role with respect to its corporate debtor if it exercises control over the debtor. Courts recognize that creditors obtain certain

118 See, e.g., Anabtawi & Stout, supra note 10, at 1271–74; Gilson & Gordon, supra note 110, at 789–803.
120 Sharp Int’l Corp. v. State Street Bank (In re Sharp Int’l Corp.), 403 F.3d 43, 52 & n.2 (2d Cir. 2005) (“The legal relationship between a borrower and a bank is a contractual one of debtor and creditor and does not create a fiduciary relationship between the bank and its borrower.”) (citations omitted).
122 Courts have suggested that “representation on the borrower’s board of directors, [or influencing] decisions as to hiring and firing, decisions as to the disposition of assets, and/or as to the shutdown of any lines of business” may impose fiduciary duties on creditors. Official Comm. of Unsecured Creditors of
types of control in the normal creditor-debtor relationship. For example, contractual provisions imposing reporting requirements on a debtor or granting a creditor veto rights over certain corporate actions are common features of most lending relationships. Accordingly, courts generally impose fiduciary duties on a creditor in only those limited circumstances where the creditor assumes the role of the debtor’s management.

C. Challenges in the Application of Traditional Controlling Stakeholder Duties

The delineation and enforcement of controlling stakeholder fiduciary duties involve at least two key challenges. First, designating a stakeholder as a corporate fiduciary rests upon an outdated model of corporate investing. Second, the controlling stakeholder determination is made on a case-by-case basis, leading to uncertainty for boards and investors alike.

1. Controlling Stakeholders as Fiduciaries

“The term ‘fiduciary’ is derived from the Latin ‘fiduciarus,’ denoting a trustee or one in a position of trust.” American fiduciary law has its roots in Roman and English law, which treated persons holding “the character of a trustee, or character analogous thereto” as fiduciaries. The original purpose of fiduciary law was to prevent persons placed in positions of trust from abusing those positions for personal gain or otherwise.


See In re Clark Pipe & Supply Co., 893 F.2d 693 (5th Cir. 1990) (“Through its loan agreement, every lender effectively exercises control over its borrower to some degree.”); see also Schwan’s Sales Enters. v. Commerce Bank & Trust Co., 397 F. Supp. 2d 189, 197 (D. Mass. 2005) (evidence that bank directed hiring and firing of management not sufficient to impose fiduciary duties); Continental Bank, N.A. v. Quality Mfrs., Inc., No. 90 C 1164, 1990 U.S. Dist. LEXIS 10417, at *21 (N.D. Ill. Aug. 9, 1990) (right to inspect confidential financial statements insufficient to impose fiduciary duties); In re Prima Co., 98 F. 2d 952, 966 (7th Cir. 1938) (bank’s right to approve certain contract between corporation and third party not sufficient to impose fiduciary duties), cert. denied, 305 U.S. 658 (1939).


Id. at 2 (“The doctrine of fiduciary relationship is a doctrine of equity, the rule being that a person must not take advantage of that relation to obtain a gift or other benefit to himself.”); see also Frank Partnoy, Robert Clark’s Corporate Law:
Early fiduciary law focused on the purpose underlying the relationship between the parties. An individual was characterized as a fiduciary for another where that individual was entrusted with property of a third party and the third party relied on the expertise and judgment of the individual with respect to all matters concerning the property. Similarly, an individual charged with managing the affairs of a third party who was otherwise incapable of doing so was characterized as a fiduciary. Accordingly, trustee- and guardianships were among the first positions of trust identified as fiduciary roles.

In many ways, early fiduciaries were objective managers of the property within their trust and control. Trustees and guardians did not have a proprietary interest in the subject property, and fiduciary law generally prohibited them from obtaining any such interest. In fact, some courts and commentators originally suggested that trustees, as fiduciaries, could not be compensated for their services.

Courts have since designated other categories of fiduciaries, including agents in the principal-agent relationship, directors and senior officers in the corporate context and partners in the partnership context. These fiduciaries exhibit traits similar, but not identical, to trustees. For example, agency is defined as a “fiduciary relationship that

---

128 See VINTER, supra note 125, at 2–3, 48–50; see also Tamar Frankel, Fiduciary Law, 71 CALIF. L. REV. 795 (1983) (explaining that “one party to a fiduciary relation (the entrustor) is dependent on the other (the fiduciary)’’); Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 N.Y.U.L. REV. 1045, 1046 (1991) (noting different theories of fiduciary duties and observing that “[i]n any of these paradigmatic forms, a beneficiary entrusts a fiduciary with control and management of an asset”).

129 See VINTER, supra note 125, at 2–3; see also Frankel, supra note 128, at 800 (“By definition, the entrustor becomes dependent because he must rely on the fiduciary for a particular service.”).

130 See VINTER, supra note 125, at 2–3.

131 As Judge Cardozo explained, “A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). See Jordan, supra note 127, at 1013 (“Trustees are subject to strict fiduciary duties of impartiality and accountability which, due to a quirk of medieval history, were enforced by a separate ecclesiastic court system known as Courts of Equity.”); see also Anabtawi & Stout, supra note 10, at 1263–64 (explaining this concept of fiduciary law—commonly referred to as the exclusive benefit rule—and its relaxed application in the corporate concept).

132 See VINTER, supra note 125, at 48 (“A trustee is not entitled to remuneration for his service, so that a gift to him from a cestui que trust is liable to be set aside.”).
arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”

Directors and senior officers manage the affairs of the corporation for the benefit of the corporation and, in most instances, its shareholders. In each of these relationships, the fiduciary has a consensual or statutory obligation to act on behalf, and for the benefit, of a third party.

As courts have expanded fiduciary law, the common traits among designated fiduciaries have become less apparent. Courts rarely focus on the purpose of the relationship between the parties and whether the fiduciary was assuming a trustee-like role. More often, they focus on

---

133 RESTATEMENT (THIRD) OF AGENCY § 1.01. An agency relationship is a consensual relationship between the principal and agent and typically involves a third person with whom the agent deals on the principal’s behalf. See id. at § 1.01, cmt. c (“As defined by the common law, the concept of agency posits a consensual relationship in which one person, to one degree or another or respect or another, acts as a representative of or otherwise acts on behalf of another person with power to affect the legal rights and duties of the other person.”).

134 See supra Part III.A; see also RESTATEMENT (THIRD) OF AGENCY § 1.01, cmt. c (“The elements of common-law agency are present in the relationships between employer and employee, corporation and officer, client and lawyer, and partnership and general partner.”).

135 See Deborah A. DeMott, Meador Lecture Series 2005-2006: Disloyal Agents, 58 Ala. L. Rev. 1049, 1050-58 (2007) (explaining consensual nature of agency relationship and that “agency law, at least in the United States, requires explicitly that an agent act ‘loyally for the principal’s benefit’ in all matters connected with the agency relationship.”) (quoting RESTATEMENT (THIRD) OF AGENCY § 8.01); see also 8 Del. C. §§ 141(a), 142 (board responsible for management of corporation; selection of officers); MODEL BUSINESS CORP. ACT §§ 8.01(b), 8.40–41 (same; functions of officers).

136 See, e.g., Deborah A. DeMott, Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences, 48 Ariz. L. Rev. 925, 934–37 (2006) (explaining the challenges in creating a unified theory of fiduciary law; “[t]he difficulty is that the characteristics of even the standard or conventional fiduciary relationships—these include trustee-trust beneficiary, agent-principal, lawyer-client, guardian-ward, director-corporation, and partner-fellow partner and partnership—are too varied to enable one to distill a single essence or property that unifies all in any analytically satisfactory way”); Easterbrook & Fischel, supra note 80, at 425 (“During the last two centuries, courts have been adapting [the trustee’s] duty of loyalty and its remedies to other . . . relations, under the title ‘fiduciary’ duty. That is adaptation, not extension.”); see also D. Gordon Smith, The Critical Resource Theory of Fiduciary Duty, 55 Vand. L. Rev. 1399, 1400-01 (2002) (same); Frankel, supra note 128, at 800-04 (same).

137 See, e.g., Pentech Pharms., Inc. v. Par Pharm., Inc., No. 04 C 3149, 2004 U.S. Dist. LEXIS 21173, at *8 (N.D. Ill. Oct. 20, 2004) (explaining that a fiduciary relationship can arise in “a relationship that constitutes something more than an ‘arms length contractual arrangement.’”); Morrison v. Gugle, 755 N.E.2d 404, 412 (Ohio App. 2001) (explaining that, in the close corporation context, “[t]he critical question is not whether one shareholder is a minority and the other a majority, but rather whether one owner so dominated the corporation that he or she can be said to have been in control to the exclusion of the other”); Waddell v. Dewey County Bank, 471 N.W.2d 591, 594 (S.D. 1991) (explaining that “the relationship
the potential for abuse in the relationship. As a result, courts frequently use fiduciary law as a means to control one party’s conduct where they perceive a potential power imbalance between the parties.\textsuperscript{138}

The potential for abuse and self-dealing underlies the designation of controlling stakeholders as fiduciaries.\textsuperscript{139} A controlling stakeholder is not a fiduciary in the traditional sense.\textsuperscript{140} A shareholder or creditor is not a trustee entrusted to manage or protect the property of third-party beneficiaries. Rather, the shareholder or creditor likely is the beneficiary in the relationship.\textsuperscript{141} State corporate law identifies the board as the entity entrusted with managing between a bank and its borrower can become a fiduciary relationship only if (1) the borrower reposes faith, confidence, and trust in the bank, (2) the borrower is in a position of inequality, dependence, weakness, or lack of knowledge, and (3) the bank exercises dominion, control, or influence over the borrower’s affairs’); see also Horejs v. Steele (In re Steele), 292 B.R. 422, 429 (Bankr. D. Colo. 2003) (explaining that the language in cases imposing fiduciary duties on corporate directors and shareholders “focus on general duties of fair dealing owed by corporate officers and directors in finding fiduciary duties rather than focusing on specific law which imposes such fiduciary duty’’); Smith, supra note 136, at 1400 (“In addition, courts regularly impose fiduciary obligations ad hoc in relationships where one person trusts another and becomes vulnerable to harm as a result.”).

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{138} See, e.g., Calvin Klein Trademark Trust v. Wachner, 123 F. Supp. 2d 731, 734 (S.D.N.Y. 2000) (“[S]pecial factors . . . [may] create fiduciary relationships between contracting commercial parties, such as, for example, when one party’s superior position or superior access to confidential information is so great as virtually to require the other party to repose trust and confidence in the first party.”); Diversified Foods, Inc. v. First Nat’l Bank, 605 A.2d 609, 614 (Me. 1992) (“The salient elements of a confidential relation are the actual placing of trust or confidence in fact by one party in another and a great disparity of position and influence between the parties to the relation.”); Peoples Bank & Trust Co. v. Cernack, 658 So. 2d 1352, 1359 (Miss. 1995) (“A fiduciary relationship may arise in a legal, moral, domestic, or personal context, where there appears ‘on the one side an overmastering influence or, on the other, weakness, dependence, or trust, justifiably reposed.’”) (citations omitted).

\item \textsuperscript{139} See Kahn v. Lynch Commc’n Sys., 638 A.2d 1110, 1120 (Del. 1994).

\item \textsuperscript{140} A trustee generally is “a person who holds property in trust.” \textsc{Rest. (Third) of Trusts} § 3. “A trust [other than a ‘resulting’ or ‘constructive’ trust] . . . , is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons.” \textsc{Rest. (Third) of Trusts} § 2. Neither shareholders nor creditors hold property in trust for others. Moreover a constructive or resulting trust typically is a remedy for wrongful conduct. \textsc{See Rest. (Third) of Trusts} § 1, cmt. e. Absent a fiduciary duty, acting in self-interest generally is not wrongful conduct. Although early case law referred to controlling shareholders as “trustees,” that analogy no longer applies to the commercial relationship between a corporation and its stakeholders. \textsc{See supra Part IV; see also Southern Pacific Co. v. Bogert, 250 U.S. 483, 492 (1919) (“[T]he doctrine by which the holders of a majority of the stock of a corporation who dominate its affairs are held to act as trustees for the minority . . . . It is the fact of control of the common property held and exercised . . . that creates the fiduciary obligation.”).

\item \textsuperscript{141} See \textsc{supra} Part II.
\end{itemize}
\end{footnotesize}
corporate affairs for the benefit of the corporation and its stakeholders.142

The roles of shareholders and creditors are converging under the influence of, among other things, private funds and other institutional investors using their equity and debt positions to achieve their activist agendas.143 Consequently, the relationship between stakeholders and the corporation is gravitating towards a more commercial rather than trust relationship.144 Stakeholders do not hold positions of trust and confidence with respect to the corporation or other stakeholders.145 Most stakeholders can buy and sell interests in the corporation (whether securities or debt instruments) in the open market.146 These transactions and stakeholders’ dealings with the corporation generally are based on public information. Consequently, any analogy between corporate stakeholders and traditional trustee-like fiduciaries is superficial and outdated.

Indeed, in the typical corporate context, the shareholder contributes capital to the corporation; the creditor extends credit or loans money to the corporation.147 Each relies on corporate management, not other stakeholders, to protect their investments and comply with their contracts. The board’s duty to act in the corporation’s best interests in turn applies whether the board is evaluating a transaction with an unrelated party or an insider.148 The board’s failure to fulfill its duty should not make the other party to the transaction a fiduciary.

142 See infra Part VI.A.
143 See supra Part IV.C.
144 A “quid pro quo” or an exchange of an item or good for another of value often is cited as “a defining characteristic of a commercial transaction.” United States v. Bailey, 115 F.3d 1222, 1236 (5th Cir. 1997). Corporations sell and shareholders buy stock; corporations sell and creditors buy bonds; lenders sell and corporations buy financial products. Each of these transactions exhibits characteristics of a commercial transaction. See, e.g., Frank B. Cross & Robert A. Prentice, The Economic Value of Securities Regulation, 28 CARDOZO L. REV. 333, 338–39 (2006) (discussing risk inherent in investment contracts and characterizing these contracts, including shareholder contract, as commercial transactions). A “commercial transaction” and a transaction involving “trust and confidence” are not mutually exclusive concepts. Nevertheless, the concept of “trust and confidence” is the traditional focus of a fiduciary transaction.
145 See, e.g., Midwest Decks v. Butler & Baretz, 649 N.E.2d 511, 518 (1995) (“The party asserting a fiduciary relationship must show that it placed its trust and confidence in another who thereby gained dominance over that party.”).
146 See supra Part IV.C. Both shareholders and creditors also can protect their interests through diversification. See, e.g., Maurice Obstfeld, Risk-Taking, Global Diversification and Growth, 84 AM. ECON. REV. 1310 (1994) (discussing investor diversification and its role in the markets).
147 See, e.g., Velasco, supra note 65, at 413 (discussing shareholder capital investment in corporation).
148 See infra Part VI.A.
Yet this fact pattern describes most controlling stakeholder cases. The board approves a transaction that benefits a controlling stakeholder to the exclusion of other stakeholders, and the controlling stakeholder’s alleged influence over the board’s decision is cited as grounds to impose fiduciary duties on the stakeholder.\footnote{See supra Part IV.D. Encouraging a fiduciary to breach its duty does not make the third party a fiduciary, but the conduct may subject the third party to aiding and abetting claims. See infra note 221.} This reasoning ignores the stakeholder’s lack of authority to make corporate decisions.\footnote{See supra Part IV.C; see also Paula J. Dalley, The Misguided Doctrine of Stockholder Fiduciary Duties, 33 Hofstra L. Rev. 175 (2004) (observing that shareholders have no statutory authority to manage general corporate affairs).} In fact, in the controlling creditor context, the contract may specifically provide that the creditor does not have such authority and is not a fiduciary for the corporation.\footnote{See, e.g., Power & Tel. Supply Co. v. SunTrust Banks, Inc., 447 F.3d 923, 928 (6th Cir. 2006) (“[T]he new . . . credit facility[] was documented by Restated Credit and Restated Security Agreements, which explicitly provided that nothing in them or any related documents created a fiduciary relationship between P&T [borrower] and either SunTrust or any participating lender.”).}

Focusing solely on a controlling stakeholder’s influence over the board also overlooks basic elements of the board-stakeholder relationship. Shareholders and creditors invest in or transact with a corporation to make a profit.\footnote{See, e.g., Velasco, supra note 65, at 413 (“Shareholders invest in corporations primarily for economic gain.”); see also Tamar Frankel & Lawrence A. Cunningham, The Mysterious Ways of Mutual Funds: Market Timing, 25 Ann. Rev. Banking & Fin. L. 235, 249–50 (2006) (explaining mutual fund motivation in equity investments); Ian B. Lee, Corporate Law, Profit Maximization, and the "Responsible" Shareholder, 10 Stan. J.L. Bus. & Fin. 31, 55–57 (2005) (discussing investor economic motivations versus ethical motivations); see also Evan D. Flaschen & Kurt A. Mayr, Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds, 26-7 ABIJ 16, 48 (2007) (“Hedge funds, like all other creditors, desire to maximize the return on their investment.”); Baird & Rasmussen, supra note 53, at 1245 (“Private lenders are not charitable institutions. They will act to maximize their rate of return when they engineer the appointment of a CRO or otherwise exercise their influence.”); Barry E. Adler, Bankruptcy and Risk Allocation, 77 Cornell L. Rev. 439 (1992) (discussing differing incentive among corporate investors).} Self-interest motivates these transactions. The law generally recognizes this fact. For example, a shareholder, even a majority shareholder, can vote its shares in a self-interested manner.\footnote{See, e.g., McMullin v. Beran, 765 A.2d 910, 919 (Del. 2000) (explaining that “a majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board’s consideration”).} A creditor has no legal duty to negotiate a contact favorable to the corporation.\footnote{For example, creditors may use restrictive covenants in their debt contracts with a corporation to influence management investment decisions in a manner that arguably contradicts with shareholders’ interests. See, e.g., Remus D. Valsan & Moin A. Yahya, Shareholders, Creditors, and Directors’ Fiduciary Duties: A Law
undertake any obligation to act in the best interest of others.\textsuperscript{155}

The law could impose this obligation on stakeholders, but the inherent conflict of interest may undermine the effectiveness of the remedy.\textsuperscript{156} Stakeholders with a vested interest in a transaction are not in a strong position to evaluate the transaction objectively. Moreover, imposing a fiduciary-like duty on these stakeholders may create a false sense of alliance between the stakeholder’s and the board’s objectives. The stakeholder and the board should be on opposite sides of the negotiating table. Acknowledging the self-interest of the stakeholder and calling on the board to assess the transaction in light of that self-interest may encourage a more thoughtful analysis by the board.

2. Uncertainty in Identifying Controlling Stakeholders

Courts generally require a plaintiff to show that a stakeholder controlled and dominated corporate affairs in order to impose fiduciary duties on that stakeholder. “‘Control’ and ‘domination’ are difficult terms to define precisely, but ‘at minimum . . . imply (in actual exercise) a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.’”\textsuperscript{157} In the controlling creditor context, something more than simple control in a commercial lending relationship—e.g., excessive control—is the standard.\textsuperscript{158}

Proving control or domination can be a difficult and fact-intensive proposition. To satisfy her burden, a plaintiff


\textsuperscript{155} In a market economy, these investors should be free to pursue their own profit-maximizing agendas, even in their negotiations and dealings with the corporation. Nevertheless, they should not be able to achieve their objectives through fraud, misrepresentation or criminal conduct. For that reason, the fairness proposal would not designate stakeholders as fiduciaries but would subject their conduct to applicable non-fiduciary law. \textit{See infra} note 238 and Part IV.C.4.

\textsuperscript{156} \textit{See infra} Part V.D.

\textsuperscript{157} Dennis J. Block et al., \textit{The Duty of Loyalty and the Evolution of the Scope of Judicial Review}, 59 BROOK. L. REV. 65, 74–75 (1993) (in the shareholder context, control is shown by majority stock ownership or actual control over board decisions).

\textsuperscript{158} \textit{See supra} Part V.B.
typically must demonstrate “‘that the directors are ‘behelden’ to [the controlling person] or so under their influence that their discretion would be sterilized.’”159 Courts further presume a director’s independence unless the plaintiff establishes that the particular director’s interest in a transaction or connection with a controlling shareholder or director impairs her judgment.160

A stakeholder’s influence over a director and that director’s resulting conflict may be subtle and not readily apparent to the outside observer.161 Board members may serve on other boards with the stakeholder, may do business with the stakeholder in ordinary course matters, may socialize with the stakeholder or may fear retribution from the stakeholder in the media or in subsequent business matters.162 Reported case law frequently deals with the easier cases of conflict or lack of independence involving directors designated or paid by the controlling stakeholder or receiving a financial benefit from the controlled transaction.163

Nevertheless, even in these easier cases, the outcome is uncertain. A stakeholder’s right to appoint directors to the board is not conclusive evidence of control.164 Likewise, a stakeholder’s ability to purchase additional shares in the open market to obtain a majority position is not sufficient.165

159 Orman v. Cullman, 794 A.2d 5, 24 (Del. Ch. 2002) (citation omitted).
160 Id.; see also Cede & Co. v. Technicolor, 634 A.2d 345, 362 (Del. 1993) (“We have generally defined a director as being independent only when the director’s decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations.”).
161 See, e.g., James D. Cox, Searching for the Corporation’s Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, 1982 DUKE L.J. 959, 1008 (noting the common grounds for conflict and lack of independence in the derivative litigation context, such as family and business relations, and observing that “[t]he more subtle malady of structural bias cannot be treated solely by noting suspect relationships and the manner of the directors’ appointment”); see also discussion of structural bias infra note 207.
162 For example, activist stakeholders often use the media or public filings to try to influence board action. See, e.g., Kahan & Rock, supra note 40, at 1029–32 (discussing activist hedge fund’s public criticism of company’s CEO); Salton Inc., Amendment (Form SC 13D/A), Ex. 1, Feb. 15, 2005 (letter to board from activist hedge fund remarking, “While [the CEO] hobnobs at such social events and is driven around in a chauffeured limousine—I can only assume he has a chauffeur paid for by the Company; how else can one explain the $52,966 annual car allowance disclosed in the Company’s proxy statement?—Salton’s shareholders and bondholders suffer.”); see also supra Part IV.A.
163 See supra Part IV.D.
164 See, e.g., In re Tyson Foods, Inc. Consol. S’holder Litig., 919 A.2d 563, 588 (Del. Ch. 2007) (“[I]t is well-settled that a director’s appointment at the behest of a controlling shareholder does not suffice to establish a lack of independence”).
165 See, e.g., In re Western Nat’l Corp. S’holders Litig., No. 15927, 2000 Del. Ch. LEXIS 82, *21 (Del. Ch. May 22, 2000) (“[T]he fact that American General could acquire a numerical majority stock interest in Western National in the open market is not sufficient to convert its status as a substantial minority shareholder to that of a fiduciary.”). But see In re Cysive, Inc., S’holder Litig., 836 A.2d 531,
A stakeholder’s threat of a hostile takeover or termination of a commercial relationship with the corporation, however, may cause the stakeholder to be treated as a fiduciary.\textsuperscript{166} This uncertainty reflects in part the reality that boards do wrestle with potential conflicts of interest and issues of divided loyalty whenever they are asked to pursue a transaction proposed by, benefiting or involving a particular stakeholder.\textsuperscript{167}

D. Expanding Fiduciary Law to Increase Stakeholder Accountability

Courts or policymakers could expand existing fiduciary law to treat activist, as well as controlling, stakeholders as fiduciaries. As noted above, Professors Anabtawi and Stout have endorsed this type of expanded fiduciary duty for activist shareholders.\textsuperscript{168} This solution would attempt to curb stakeholders’ self-interest in their dealings with the corporation. It also would allow the corporation and injured stakeholders to seek damages directly from the controlling stakeholders.\textsuperscript{169} Imposing fiduciary duties on a controlling or activist stakeholder has the appeal of punishing the party perceived to be profiting at the expense of the minority.\textsuperscript{170}

Expanding fiduciary law to include activist stakeholders may address the potential for abuse in stakeholder transactions. The success of this approach would depend on several factors, including the risk appetite of the stakeholders, the subtlety of their control or activism and whether their vision for the corporation was aligned with or viewed as contrary to the wealth-maximizing potential of the corporation.\textsuperscript{171} This approach may, however, also increase the uncertainty in controlling stakeholder fiduciary

\textsuperscript{552} (Del. Ch. 2003) (considering “the votes of [the 35% shareholder’s] subordinate Lund and family members” in holding that shareholder was a controlling shareholder).

\textsuperscript{166} See, e.g., Kahn v. Lynch Commc’n Sys., 638 A.2d 1110, 1120 (Del. 1994) (threat of hostile takeover may support breach of fiduciary duty claim against controlling shareholder); Williamson v. Cox Commc’ns, Inc., No. 1663N, 2006 Del. Ch. LEXIS 111, at *20–*22 (Del. Ch. June 5, 2006) (commercial relationship between shareholders and corporation may support finding of control); see also \textit{supra} Part IV.B.

\textsuperscript{167} See \textit{supra} Part V.C.2.

\textsuperscript{168} See Anabtawi & Stout, \textit{supra} note 10, at 1294 (proposal for extending controlling shareholder fiduciary duties to activist shareholders).

\textsuperscript{169} See id.

\textsuperscript{170} See \textit{id.} at 1294 (“We suggest treating the underlying disease [i.e., shareholder opportunism], rather than merely trying to ameliorate its symptoms.”).

\textsuperscript{171} See \textit{supra} Part V.C.2.
Stakeholders often look to controlling or activist stakeholders to monitor the board and for signals regarding corporate performance. Stakeholders as monitors can provide valuable information to other stakeholders and the markets generally. Controlling or activist stakeholders have the incentive and resources to perform this monitoring role. Monitoring in turn may reduce the agency costs inherent in the dispersed ownership model.

Any proposed solution for governing controlled transactions should consider the role of the controlling stakeholder as monitor. The impact of expanding stakeholder fiduciary duty on corporate monitoring is unknown. In light of the controlling stakeholder’s self-interest in monitoring, the impact may be nominal. Nevertheless, potential fiduciary duties may deter some

---

172 See id. Certainty promotes effective corporate law. See, e.g., In re Topps Co. Shareholders Litig., 924 A.2d 951, 958 (Del. Ch. 2007) (acknowledging value of “efficient and predictable corporation law”). Corporate law in turn can bolster investor confidence. See, e.g., Rafael La Porta et al., Investor Protection and Corporate Valuation, 57 J. Fin. 1147, 1166-69 (2002) (explaining role of minority protections in investor confidence and corporate value); Rafael La Porta et al., Investor Protection and Corporate Governance, 58 J. Fin. Econ. 3, 4 (2000) (“Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders.”); Black, supra note 34, at 835-40 (explaining role of investor protections in creating strong securities market). An expanded concept of controlling or activist stakeholder as fiduciary also further removes this designated corporate fiduciary from the trusteeship origins of fiduciary law. See supra Part V.C.1.

173 See, e.g., Judy Hyde, New GM Raider Not Likely: Other Big Investors Are Institutions, DETROIT FREE PRESS, Dec. 2, 2006 (“[S]ome observers see Kerkorian’s transaction [e.g., selling GM stock] as a signal to investors that there are better places to wager their money for now.”); Chad Brand, What Does a 3.5% Stake by Ackman’s Activist Firm Pershing Square Mean For Sears? THE PERIODICAL CAPITALIST, Oct. 5, 2007 (“There are two possible reasons we could be excited about the news that Pershing Square has amassed a $700 million stake in Sears; it represents a new investment by a very smart value investor, and it signals that Ackman plans to take a large activist role with the company and management, leading to changes that will unlock shareholder value.”); Brinks Could See Sell Soon, SECVINVESTOR.COM, Dec. 18, 2006 (“The fundamental valuation of the company along with this coalition of activist shareholders bent on unlocking value make BCO a stock worth watching in the next couple of months.”)

174 See supra Part III.B; see also Mark J. Roe, Corporate Law’s Limits, 31 J. Legal Stud. 233, 247–48 (2002) (explaining in the context of a study assessing causes and depths of agency costs that controlling shareholders “provide critical good services to the firm and one powerful bad service: the good ones are monitoring managers, facilitating information flow from inside the firm to capital owners, and making implicit deals with stakeholders when soft deals are efficient; their one big bad activity is their stealing from the minority stockholders”).

175 See Anabtawi & Stout, supra note 10, at 1304–06 (acknowledging potential chilling effect of treating activist shareholders as corporate fiduciaries but suggesting that such concern may be overstated and that any resulting restrictions on activism may be warranted).
activist stakeholders from monitoring or publicly announcing their interests in a corporation.\textsuperscript{176}

VI. An Alternative to Controlling Stakeholder Duties

The potential for controlling stakeholders to, among other things, freeze out the minority, negotiate below market commercial contracts and use their positions to purchase corporate assets illustrates the need to scrutinize strictly controlled transactions.\textsuperscript{177} The board should provide this enhanced oversight to protect corporate investments and promote investor confidence.

A. The Board as Fiduciary

Corporate law designates the board as manager of corporate affairs.\textsuperscript{178} The board is entrusted with the corporation’s property and is expected to manage that property for the corporation’s benefit. Most directors have limited proprietary interests in the corporation, and existing law generally proscribes or sharply limits transactions between a director and the corporation.\textsuperscript{179} The board occupies a position of trust and confidence—i.e., a fiduciary position—with respect to the corporation.\textsuperscript{180}

The board’s fiduciary role places it in a strong position to evaluate and protect the corporation against controlled transactions. The board evaluates proposals from shareholders and contracts with creditors.\textsuperscript{181} The board has the resources to assess these transactions and determine the best course for the corporation.\textsuperscript{182} The board’s evaluation

\textsuperscript{176} Some commentators suggest that existing restrictions, without imposition of a fiduciary duty, on shareholder monitoring may deter beneficial activism. See, e.g., Illig, supra note 32, at 249–53; see also Black, supra note 38, at 523; Mark J. Roe, A Political Theory of American Corporate Finance, 91 COLUM. L. REV. 10, 11 (1991).
\textsuperscript{177} See, e.g., supra Part III.D; Anabtawi & Stout, supra note 10, at 1271–74 (discussing minority freeze-outs).
\textsuperscript{178} See, e.g., 8 DEL. C. §§ 141(a), 142 (board responsible for management of corporation; selection of officers); MODEL BUS. CORP. ACT §§ 8.01(b), 8.40–41 (same; functions of officers).
\textsuperscript{179} See, e.g., 8 DEL. C. § 144 (standards for ratification of interested director transactions); see also Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (explaining that public policy “has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty”).
\textsuperscript{180} As discussed above, the board is not a traditional trustee with respect to the corporation. Corporate law has relaxed certain aspects of fiduciary law for directors. See supra Part V.C.1.
\textsuperscript{181} See supra Part IV.A; see also Thomas A. Russo, Beyond SOX 404, 9 STAN. J.L. BUS. & FIN. 281, 290–93 (2004) (discussing board responsibilities in the context of integrated risk management and corporate governance).
\textsuperscript{182} See Russo, supra note 181, at 290–93.
process should consider both the short- and long-term effects of the transaction.

For example, in a shareholder-proposed transaction, the board is well-equipped to assess the transaction. The board, with the assistance of management and professionals, understands the corporation’s business and whether the proposed transaction presents a positive net present value opportunity for the corporation. It also has the resources to identify the conflicts inherent in the transaction and to factor those conflicts in the transaction’s valuation. Likewise, in a financing transaction, the board has the ability through risk management activities and other measures to, among other things, determine and mitigate the impact of the contract provisions being negotiated with lenders and key customers. In theory, boards are in a better position to protect the corporation against controlled transactions, particularly as boards increase the number of independent board members. A controlling or interested stakeholder necessarily will view the proposed transaction from its favored vantage point. Mandating through fiduciary duty law that the controlling stakeholder do otherwise may dress up, but likely will not change, the outcome. The board itself thus should be more objective in its assessment of the transaction. In practice, however, boards appear unable or unwilling to make the difficult decisions necessary to protect the corporation. A board must have the fortitude to stand up to the controlling stakeholder to fulfill its fiduciary role in the controlled transaction context. Saying no to shareholders or creditors who either control the directors’

183 See supra Part IV.A.
185 See Joel Seligman, A Modest Revolution in Corporate Governance, 80 NOTRE DAME L. REV. 1159, 1170 (2005) (explaining board independence requirements under the Sarbanes-Oxley Act and NYSE and NASDAQ listing requirements).
186 See supra Parts V.C and V.D.
187 See supra Part VI.A.
re-election to the board or the corporation’s cash flow is not easy.\textsuperscript{189} Ideally the law should provide the board with both incentives to scrutinize these transactions carefully and leverage to fend off controlling stakeholders.\textsuperscript{190}

B. The Board’s Role in Controlled Transactions

Several factors may explain board passivity in controlled transactions.\textsuperscript{191} Loyalty to the controlling stakeholder, self-preservation, shareholder bias, a perceived lack of leverage and perhaps general apathy all may contribute to the problem.\textsuperscript{192} In addition, the limited judicial oversight applicable to most board decisions must be considered. The protection afforded to boards by the business judgment rule may foster and shield board passivity even in the context of conflicts of interest.\textsuperscript{193}

The business judgment rule is a presumption that board decisions are made in good faith, on an informed basis and in the best interests of the corporation.\textsuperscript{194} A plaintiff challenging a board’s decision may rebut the presumption

\textsuperscript{189} See, e.g., Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (explaining that in controlled transactions, “the controlling shareholder will continue to dominate the company regardless of the outcome of the transaction. The risk is thus created that those who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation by the controlling shareholder.”) (citations omitted).

\textsuperscript{190} See infra Part VI.C.1; see also DeMott, supra note 188, at 251 (“The fact that the corporation has a majority shareholder does not relieve directors of their fiduciary duties of care and loyalty; domination is not a defense to claims arising from the breach of duties owed to minority shareholders or, for that matter, to nonshareholder third parties.”).

\textsuperscript{191} In a prior article, I refer to this development in the corporate restructuring context as “management neutrality.” Harner, supra note 188, at Part IV.C. Regardless of the financial condition of the corporation, the concept suggests a shift in management responsibilities from the board to the controlling shareholder.

\textsuperscript{192} See supra Part V.C.2.

\textsuperscript{193} See infra notes 197 and 198. In general, courts do not review the substance of board decisions protected by the business judgment rule. See, e.g., Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (“As for the plaintiffs’ contention that the directors failed to exercise ‘substantive due care,’ we should note that such a concept is foreign to the business judgment rule.”).

\textsuperscript{194} Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); see also Stanziale v. Nachtomi (In re Tower Air, Inc.), 416 F.3d 229, 238 (3d Cir. 2005) (same); Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.), 906 A.2d 27, 52 (Del. 2006) (same); MODEL BUS. CORP. ACT § 8.30(a)-(b). Commentators frequently debate whether the business judgment rule extends to decisions by senior management. See, e.g., Lyman P.Q. Johnson, Corporate Officers and the Business Judgment Rule, 60 BUS. LAW. 439, 439-440 n.6 (2005) (“‘There is little law on the subject of the liability of corporate officers who are not directors.’”); Lawrence A. Hamermesh and A. Gilchrist Sparks III, Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson, 60 BUS. LAW. 865 (2005); see also Bank of Am. v. Musselman, 222 F. Supp. 2d 792, 797 n. 10 (E.D. Va. 2002) (collecting cases). For purposes of this article, I treat directors and senior management in a similar manner with respect to fiduciary duties and judicial review.
by showing gross negligence, waste, self-dealing, fraud or other similar conduct by the board.\textsuperscript{195} If the presumption is rebutted, the board bears the burden of establishing that the decision was fair to the corporation.

The business judgment rule plays an important role in limiting judicial intervention in corporate affairs, thereby preserving the independent management role of the board. “[U]nder this familiar rule of American jurisprudence, the courts refrain from second guessing business decisions made by corporate directors in the absence of a showing of fraud, unfairness or overreaching.”\textsuperscript{196} Management, as the business experts, should have discretion with respect to ordinary course business matters and transactions between the corporation and unrelated third parties. The business judgment rule may be counterproductive, however, in the controlling stakeholder context discussed here.

Under existing law, board approval of a controlled transaction may be subject to review under the business judgment standard.\textsuperscript{197} The lower standard of review is applicable when the transaction involves a shareholder, but the plaintiff is not able to show that the shareholder controlled or dominated a majority of the board.\textsuperscript{198} As discussed above, a plaintiff may encounter significant hurdles in proving the requisite control or domination.\textsuperscript{199}

\textsuperscript{195} See, e.g., Brehm, 906 A.2d at 52.
\textsuperscript{196} See, e.g., Capital Bancshares, Inc. v. F.D.I.C., 957 F.2d 203, 207 (5th Cir. 1992). See, e.g., Block et al., supra note 157, at 72-75 (explaining requirements for invoking heightened scrutiny of controlled transactions and noting that, absent a showing of majority ownership or actual control, the challenged transaction may be reviewed under the business judgment rule); see also In re Western Nat’l Corp. S’holders Litig., No. 15927, 2000 Del. Ch. LEXIS 82, *86 (Del. Ch. May 22, 2000) (same; “Delaware law will not attach liability to decisions of independent, disinterested and informed directors.”). In addition, if the plaintiff does not allege sufficient facts to invoke the duty of loyalty, the directors may be protected by an exculpatory clause in the corporation’s articles of incorporation. \textsuperscript{197} See, e.g., 8 Del. C. § 102(b)(7) (articles of incorporation may include “[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director . . . ”). See, e.g., In re Cysive, Inc., S’holder Litig., 836 A.2d 531, 550 (Del. Ch. 2003) (“If the defendants can convince the court that the large block holder is not a controlling stockholder, then the presence of an independent board majority will invoke the business judgment rule standard of review, leading to probable victory for the defendants without the need for trial.”); In re Western Nat’l Corp. S’holders Litig., , No. 15927, 2000 Del. Ch. LEXIS 82, *87–*89 (Del. Ch. May 22, 2000) (explaining that “[t]he policy rationale requiring some variant of entire fairness review . . . substantially, if not entirely, abates if the transaction in question involves a large though not controlling shareholder” and invoking business judgment review because “[t]he facts of this case . . . hold out little if any prospect for retaliation against the Company’s public shareholders”). See supra Part V.C.2.
If actual control or domination is shown, the controlled transaction is subject to review under the entire fairness standard. The heightened burden imposed on the controlling shareholder and any interested directors may nonetheless be eased if the transaction is approved by a fully informed majority of disinterested directors or shareholders. Approval by disinterested directors or shareholders generally shifts the burden of proof to the plaintiff to show that the transaction was unfair to the corporation.

In light of the benefits derived from disinterested director approval, boards routinely appoint “special committees” of disinterested directors to review and approve controlled transactions. Some courts have endorsed this practice as a means to cleanse interested director or shareholder transactions. As a result, the plaintiff bears the burden of proof in most controlled transaction litigation.

C. Increasing Board Accountability in Stakeholder Transactions

The board’s accountability in controlled transactions is uncertain and often based on the allegations set forth in the complaint and the forum in which the complaint is filed. The fairness proposal seeks to increase certainty in the law governing stakeholder transactions. It identifies a single fiduciary and provides a uniform standard of review. It also attempts to strike an appropriate balance between the rights of individual investors and those of the corporation and its stakeholders generally. Accordingly, the proposal...
encourages the board on the one hand, and stakeholders on the other, to fill the roles for which they are best suited—the board acting as corporate decisionmaker and stakeholders acting as corporate monitors.

1. Key Elements of the Fairness Proposal

The fairness proposal would include and govern transactions with not only majority shareholders and those traditionally characterized as controlling shareholders or creditors, but also activist stakeholders. A stakeholder transaction would include any out of the ordinary course of business transaction with or supported by an existing stakeholder that benefits such stakeholder at the expense of the corporation. Representative transactions might be mergers, recapitalizations, share repurchases, asset sales and debt refinancing transactions.

The fairness proposal would presume a conflict of interest with respect to the entire board. This presumption would not automatically subject the board to challenge on every stakeholder transaction. Rather, the proposal incorporates safeguards to target only those transactions that favor the interests of a particular stakeholder and in turn impair corporate value. In addition, the proposal would impose a


206 The concept of stakeholder transactions focuses on out of the ordinary course contracts between a stakeholder and the corporation (e.g., refinancing agreements and asset or stock purchase agreements); mergers or acquisitions in which a stakeholder holds interests in both the target and acquiring corporations; targeted share repurchase agreements; and similar transactions. Ordinary course business matters generally include “any matter which transpires as a matter of daily custom in business.” Eagle-Picher Indus v. Caradon Doors & Windows, Inc. (In re Eagle-Picher Indus.), 278 B.R. 437, 451 (Bankr. S.D. Ohio 2002); Medigroup, Inc. v. Schildknecht, 463 F.2d 525, 529 (7th Cir. 1972) (approving jury instruction defining ordinary course of business as “that course of conduct that reasonable prudent men would use in conducting business affairs as they may occur from day to day”).

207 The presumption of conflict would prevent the board from using a special committee of “disinterested” directors to approve the transaction. Even where directors lack a direct personal or financial interest in the transaction, structural bias may impair their analysis. See Regina F. Burch, The Myth of the Unbiased Director, 41 Akron L. Rev. 509, 544–49 (discussing a recent Yale empirical study supporting “the notion that cognitive bias impacts board decision-making in a way that may harm shareholders” and suggesting that this cognitive bias may lead to boards “systematically underestimating the risks of conflict transactions”); Cox, supra note 161, at 962, 1008 (explaining nature of structural bias on corporate boards and recommending that, in the special litigation committee context, “[t]he most effective remedy for structural bias is to require courts to take a more active role in their review of the directors’ recommendation”).

© 2009 by Michelle M. Harner.
relatively short statute of limitations for challenging any stakeholder transaction.\textsuperscript{208}

A plaintiff challenging a stakeholder transaction would need to establish her standing to bring the lawsuit, as well as the elements of her prima facie case.\textsuperscript{209} To meet the latter, the plaintiff would need to show that the transaction: (a) was not in the ordinary course of the corporation’s business; (b) involved an existing shareholder, creditor or other stakeholder or group of existing stakeholders; (c) provided a unique benefit to those stakeholders; and (d) thereby caused relative economic injury to the corporation or minority holders.\textsuperscript{210} To meet the third element of a stakeholder transaction, a plaintiff would need to produce some evidence that the stakeholder received a benefit different from or in addition to that received by other shareholders or, if the stakeholder is a creditor, a benefit different from or in addition to its existing contract rights. A transaction between a corporation and one of its stakeholders, without more, would not be sufficient to support the plaintiff’s claim.

\textsuperscript{208} A short statute of limitations (e.g., three months after disclosure of the transaction) would help ensure that parties affected by the transaction pursue any challenge in a timely manner. This approach also would limit the board’s exposure and perhaps prevent subsequent events from tainting the courts review of the challenged transaction. See Jeffrey J. Rachlinski, A Positive Psychological Theory of Judging in Hindsight, 65 U. Chi. L. Rev. 571, 576 (1998) (explaining the phenomenon of hindsight bias in the legal system and noting that “[r]esearch by cognitive psychologists has shown that the folk wisdom on hindsight is correct—past events seem more predictable than they really were”); see also Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (observing that “after-the-fact litigation is a most imperfect device to evaluate corporate business decisions”).

\textsuperscript{209} A plaintiff’s standing to bring the lawsuit would depend on applicable law governing derivative actions. See Fed. R. Civ. P. 23.1; see also Kanter v. Barella, 489 F.3d 170, 176 n.5 (3d Cir. 2007) (explaining that, in the derivative context, Federal Rule of Civil Procedure 23.1 “requires plaintiffs to ‘allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority . . ., and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.’”) (quoting Fed. R. Civ. P. 23.1). If a plaintiff is able to show injury to her particular interests, she may be able to establish a direct claim against the board in a stakeholder transaction. See, e.g., Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004) (explaining that whether a plaintiff holds a direct or derivative claim depends on “[w]ho suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy”). A direct action most likely would be the exception rather than the rule.

\textsuperscript{210} A plaintiff would be required to establish corporate damage as part of her prima facie case before the burden of proof shifts to the board to show that the stakeholder transaction was fair to the corporation. The pleading standard would be similar to that required for a plaintiff to rebut the business judgment presumption. See, e.g., In re General Motors Class E Stock Buyout Sec. Litig., 694 F. Supp. 1119, 1132 (D. Del. 1988) (“[I]n order to overcome the presumption of the business judgment rule [the plaintiff] must allege with particularity facts which establish that the contested decision was not a product of valid business judgment.”).
If the plaintiff made the required showing, the board then would bear the burden of proof to show that the stakeholder transaction was fair to the corporation.\textsuperscript{211} The entire fairness standard of review generally requires the board to show fair dealing and fair price with respect to the challenged transaction.\textsuperscript{212} Fair dealing “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”\textsuperscript{213} Fair price “relates to the economic and financial considerations of” the challenged transaction.\textsuperscript{214}

The board could shift the burden of proof to the plaintiff by showing that the board exposed the stakeholder transaction to a meaningful market test prior to approving the transaction. In this context, “market test” does not necessarily mean putting the company in play or undertaking an auction-like process.\textsuperscript{215} Rather, the board could satisfy this test by presenting “a sufficient body of reliable evidence” that it considered reasonable alternatives to, and adequately tested the value of, the proposed transaction.\textsuperscript{216} The fairness proposal seeks to protect the

\textsuperscript{211} A plaintiff’s ability to allege facts and produce some evidence of economic injury to the corporation to sustain her prima facie case would not necessarily lead to the avoidance of the transaction. The board may still be able to show by a preponderance of the evidence that the transaction was fair to the corporation. For example, in the context of an asset sale, the board may have data, including projections and business forecasts, or expert valuations that establish the fairness of the transaction despite the plaintiff’s allegations of damage.

\textsuperscript{212} See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). The entire fairness standard should apply to boards’ decisions on stakeholder transactions in bankruptcy as well. For example, under existing law, if a debtor corporation wants to sell its assets to an existing stakeholder, bankruptcy courts generally review this type of transaction under the business judgment rule. Likewise, if the debtor corporation proposes a postbankruptcy financing facility, commonly referred to as a debtor-in-possession financing facility, with its prebankruptcy lenders, the court should review this transaction under the entire fairness and not the business judgment standard. This heightened judicial scrutiny of stakeholder transactions in bankruptcy would better protect the bankruptcy estate. See Harner, supra note 55, at 98–103 (discussing the potential abuse of stakeholder transactions in bankruptcy, the limitations on existing judicial review and the proposal of an estate representative).

\textsuperscript{213} Weinberger, 457 A.2d at 703.

\textsuperscript{214} Id.

\textsuperscript{215} Case law dealing with the sale of corporate control, such as Revlon, Inc. v. MacAndrews & Forbes holdings, Inc., 506 A.2d 173 (Del. 1986) and its progeny, would be instructive on, but not determinative of, this factor. As noted, the market test discussed here does not mandate an auction process. In this regard, it also is broader and more flexible than the market test incorporated into section 5.15(b) of the American Law Institute’s Principles of Corporate Governance. See PRINCIPLES OF CORPORATE GOVERNANCE, supra note 93, at § 5.15(b).

interests of the corporation in its dealings with existing stakeholders, a situation where subtle influence and self-interest may impact value. Exposing a stakeholder transaction to competitive pricing and market alternatives furthers that objective and should result in some protection for the board’s decision.

2. Consequences Under the Fairness Proposal

The consequences of any given stakeholder transaction litigation would turn largely on the underlying facts and the evidence presented by the parties. For example, if a plaintiff lacks standing to bring a derivative action or fails to establish a unique benefit to the involved stakeholder or economic injury to the corporation, the litigation most likely would be dismissed. If the action survives a motion to dismiss and the defendants present sufficient evidence of a meaningful market test, the action may be resolved in the defendants’ favor at the summary judgment stage or, if it proceeds to trial, the burden of proof would shift to the plaintiff to establish that the transaction was unfair to the corporation.217

If the board does not subject the stakeholder transaction to a market test, then the board would continue to bear the burden of proof to show that the transaction satisfies the entire fairness test.218 If the stakeholder transaction is

control, “a sufficient body of reliable evidence demonstrating competent knowledge of the company’s market may also be persuasive evidence of the directors’ good faith discharge of their fiduciary duties and pursuit of the best transaction available to the stockholders”); see also MCCORMICK ON EVIDENCE § 339 (Strong ed., 5th ed. 1999) (“The most acceptable meaning to be given to the expression, proof by a preponderance, seems to be proof which leads the jury to find that the existence of the contested fact is more probable than its nonexistence.”). The two key elements of the market test discussed here are (i) exploring reasonable alternatives to the stakeholder transaction, which would include rejecting the transaction and maintaining the status quo, and (ii) using a competitive process or other market mechanism to test the adequacy of the price. Notably, some stakeholder transactions may not lend themselves to a market test; the board would need to meet the traditional entire fairness test with respect to those transactions.

217 See supra Part VI.C. Because the fairness proposal presumes that a conflict of interest or potential undue influence exists in stakeholder transactions, the standard remains entire fairness even after the burden of proof shifts to the plaintiff. For similar reasons, approval of the transaction by apparently disinterested directors would not provide a safe harbor for the transaction. See supra notes 161 and 207.

218 A board’s failure to subject a stakeholder transaction to a market test does not necessarily render the transaction unfair. “A finding of perfection is not a sine qua non in an entire fairness analysis.” Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995). “Rather, it is a standard by which the Court of Chancery must carefully analyze the factual circumstances, apply a disciplined balancing test to its findings, and articulate the bases upon which it decides the ultimate question of entire fairness.” Id.
determined to be fair to the corporation, the directors would not face liability and the transaction would not be subject to avoidance. If the directors cannot satisfy the entire fairness test, the directors would face liability for breaches of their duty of loyalty and the transaction would be subject to avoidance.\(^{219}\)

The fairness proposal also would affect adversely the stakeholders involved in the transaction. If the transaction is avoided, the interested stakeholders lose any benefit from and any investments in the transaction.\(^{220}\) In addition, if the stakeholder is a director or has an employee serving as a representative director on the board, the stakeholder may be liable for breaching the duty of loyalty either directly or indirectly under indemnification obligations or an aiding and abetting theory.\(^{221}\) Accordingly, although the stakeholder itself would not be subject to fiduciary duties,

\(^{219}\) Approving a transaction that is not fair to the corporation constitutes a breach of a director’s duty of loyalty. See, e.g., Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993) (“[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.”).

\(^{220}\) See, e.g., Thomas v. Brownville, Fort Kearny Pac. Railroad Co., 109 U.S. 522, 524 (U.S. 1883) (voiding interested director transaction and explaining, “The original contract being such that the contractors can maintain no suit on it, the bonds which they received are affected with the same vice, and cannot be enforced unless they are negotiable instruments in the hands of innocent holders for value.”); Todd v. Southland Broadcasting Co., 231 F.2d 225, 232 (5th Cir. 1956) (“Where the proof showed that the action of the board of directors was not binding upon the corporation, the plaintiff was entitled to recover from Martin the money which had been paid to him under that invalid order, unless Martin could show himself entitled to retain it by reason of the fact that he had performed valuable services to the corporation for which he would be entitled to just compensation.”) (citations omitted); Sunrise Island v. Goldman Sachs & Co. ex rel. Ballard (In re Sunrise Island), 203 B.R. 171, 175 (Bankr. N.D. Okla. 1996) (voiding loan and accompanying collateral package as an interested director transaction); Cahall v. Lofland, 114 A. 224, 232 (Del. Ch. 1921) (“Special contracts to pay compensation to directors for extra services are everywhere and always voidable if carried by votes of interested directors. Therefore, even if the services rendered by the directors were extraordinary and outside their duties as directors, still they could not have recovered pay therefor in an action . . . .”) (citations omitted).

\(^{221}\) A claim for aiding and abetting a breach of fiduciary duty generally requires a showing that “a) that the fiduciary’s conduct was wrongful; b) that the defendant had knowledge that the fiduciary’s wrongful conduct was occurring; and c) that the defendant’s conduct gave substantial assistance or encouragement to the fiduciary’s wrongful conduct.” Rosener v. Majestic Management, Inc. (In re OODC, LLC), 321 B.R. 128, 144 (Bankr. D. Del. 2005).

Although a controlling stakeholder’s designated representative on the board may be an agent of that stakeholder, courts generally have rejected claims of respondeat superior in the breach of fiduciary duty context. See Global Crossing Estate Representative v. Winnick, No. 04 Civ. 2558, 2006 U.S. Dist. LEXIS 53785 (S.D.N.Y. Aug. 3, 2006) (explaining rejection of theory under New York and Delaware law).
the stakeholder could still incur liability resulting from the stakeholder transaction.

3. Advantages of the Fairness Proposal

The fairness proposal primarily targets significant transactions between a corporation and one or more of its existing shareholders or creditors. It acknowledges that existing stakeholders may have interests in those transactions that do not necessarily align with the best interests of the corporation.\(^{222}\) It also recognizes that proving a stakeholder’s control, domination or even influence over the board’s decision in any given transaction is difficult. Accordingly, the fairness proposal does not require such proof, but presumes the existence of some influence if the transaction provides a benefit to the stakeholder different from its existing entitlements.\(^{223}\)

The fairness proposal also encourages disclosure and a more thorough ex ante review of stakeholder transactions. For example, the fairness proposal bases the statute of limitations on the date of disclosure of the transaction to stakeholders generally.\(^{224}\) In addition, a board may ease its burden and significantly bolster its case by fully informing itself of the transaction’s market value and exploring alternatives for the corporation, which would include rejecting the transaction and maintaining the status quo.\(^{225}\) Although boards should undertake this type of thoughtful review in all instances, the fairness proposal provides incentives to encourage this review in stakeholder transactions where outside influences may otherwise impair the board’s judgment and corporate value.

VII. Potential Concerns with the Fairness Proposal

The fairness proposal is not a perfect solution to the potential for abuse inherent in controlled transactions. The proposal nonetheless attempts to strike an appropriate balance between protecting corporate interests and preserving the economic rights of individual stakeholders. Proponents of shareholders rights, critics of activist stakeholders and those concerned with increasing board liability each might propose a different mechanism for addressing controlled transactions. The fairness proposal

\(^{222}\) See supra Part V.C.
\(^{223}\) See supra Part VI.C.1.
\(^{224}\) See id.
\(^{225}\) See id. and supra note 216.
considers and tries to account for each of these competing interests.

A. Shareholders Should Have More Control

Some commentators argue that shareholders should possess more rights with respect to, and control over, the corporation.226 This position views shareholders as holding true proprietary, and not merely economic, interests in the corporation. It seeks to bolster the proposition that the corporation should be managed for the sole benefit of shareholders.227

Commentators posit different theories of basic corporate governance issues, including whether shareholders are the residual owners of the corporation and whether the corporation should be managed exclusively for the benefit of shareholders.228 The fairness proposal does not rely upon one particular theory. Regardless of how a shareholder’s interest in the corporation is characterized, the shareholder should have the ability to pursue value-enhancing transactions for that interest and should not be required to sacrifice its self-interest for other shareholders.229

Unfettered shareholder control in the controlled transaction context, however, would undermine investor confidence and potentially undervalue corporate assets.230 The board is best equipped to filter proposed controlled transactions and assess their impact on corporate value. If non-controlling stakeholders believe that the board is incapable of performing this function, they can challenge the transaction and, under the fairness proposal, the court would determine

226 See, e.g., Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 VA. L. REV. 675 (2007) (suggesting corporate reforms to increase shareholders’ rights, including their power to remove directors).

227 Id. at 682 (“[A] viable shareholder power to replace directors ... is necessary to provide directors with strong affirmative incentives to focus on shareholder interests.”).

228 See citations supra note 85.

229 The fairness proposal is designed to protect corporate value. Accordingly, the proposal’s focus on stricter board accountability does not necessarily imply accountability to shareholders versus other stakeholders. Nevertheless, the practical effect of the proposal may be that the benefits of enhanced corporate value flow to shareholders of a solvent company and to creditors of an insolvent company.

230 See supra Part VI; see also Stout, supra note 85, at 801-02 (observing that investors gravitate to board governance models, suggesting value in those models); John Armour et al., Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom, 55 VAND. L. REV. 1699, 1714 (2002) (reviewing empirical data and observing that “[s]tronger legal protection for minority shareholders is associated with a larger number of listed companies, more valuable stock markets, lower private benefits of control, and a lower concentration of ownership and control”).

© 2009 by Michelle M. Harner. 50
the fairness of the transaction to the corporation. Stakeholders can protect their interests by monitoring the board; the board can protect corporate interests by monitoring, among other things, controlling stakeholders; and the courts can ensure that challenged transactions are fair to the corporation.

B. Controlling Stakeholders Should Have Less Control

Activist stakeholders often are characterized as “vulture” investors who seek to siphon value out of corporations in a relatively short timeframe, without regard to the long-term prospects of the corporation. This characterization aptly describes some activist investors, and commentators are right to question their motives and raise concerns about their impact on corporate value. Not all activist stakeholders, however, fall into this category and many have illustrated an ability to appreciate longer-term objectives of the corporation and to serve as effective corporate monitors.

Imposing fiduciary duties on all controlling or activist investors may or may not curb their self-interest. Many activist investors already factor fiduciary duty into their strategies and seek board appointments for themselves or their representatives. Those activist stakeholders may rationalize that their interests align with any imposed fiduciary duties, pursuing transactions that enhance the value of their holdings and, from their vantage point, overall corporate value. The corporation and other stakeholders may view the transaction differently, and the transaction may in fact be value destructive. Controlling or activist

---

231 See supra Part VI.C.1.
232 This system of checks and balances often is advanced to support increased stakeholder activism. See, e.g., Black, supra note 34, at 817 (explaining benefits of institutional investors monitoring management and management monitoring investors in the context of removing barriers to institutional investor activism). The fairness proposal invokes this system with the back-stop of judicial review of the fairness of any controlled transaction. See supra Part VI.C.1.
233 See ROSENBERG, supra note 44 (referring to activist distressed debt investors as vultures); Rich Pickings, FUND STRATEGY, Apr. 3, 2006, at 20 (“Vultures are basically value investors, trying to buy an asset for a price well below its intrinsic or fair value.”).
234 See, e.g., Bratton, supra note 40, at 1410–22 (study suggesting that some private funds may generate value at their corporate targets); see also Brav et al., supra note 50; Hotchkiss & Mooradian, supra note 44.
235 See, e.g., Briggs, supra note 45, at 718–21 (discussing hedge fund representation on boards).
236 See id. at 718–21 (citing successes of activist board representation and suggesting that “[t]hey therefore presumably believe that they will make more money with board representation, even minority representation, than without”).
stakeholders are not objective participants in stakeholder transactions and suggesting that the law can make them objective is a fallacy.

The fairness proposal recognizes this fallacy and, accordingly, contemplates pure economic consequences for the controlling stakeholder, including potential avoidance of the transaction and indirect liability for any representative director’s breach of her duty of loyalty. These economic consequences, which are similar to those that would be imposed if the stakeholder itself was treated as a fiduciary, may help deter abuse and provide the board with leverage in the negotiation of any stakeholder transaction. The controlling stakeholders also would continue to be subject to non-fiduciary law, including fraud, misrepresentation, equitable subordination and fraudulent conveyance law.

C. Independent Directors Should Not Face Increased Liability

Any corporate governance proposal that increases board liability potentially could deter qualified individuals from serving on boards. The deterrent effect is of particular concern where the goal of the proposal is to improve corporate management. Qualified individuals are essential to good management. Yet enhanced board responsibilities often are necessary to foster that same goal. This tension can

237 See supra note 221 and accompanying text.
238 See supra Part IV.C.4; see also In re Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006) (explaining and evaluating potential claims against a controlling stakeholder, including aiding and abetting, deepening insolvency, equitable subordination, fraudulent conveyance and recharacterization); Liafail, Inc. v. Learning 2000, No. 01-599 GMS, 2002 U.S. Dist. LEXIS 22620 (D. Del. Nov. 25, 2002) (explaining elements of fraud in the inducement and negligent misrepresentation claims); Hauspie v. Stonington Ptnrs., Inc., 945 A.2d 584 (Del. 2008) (explaining elements of common law fraud claim). Although similarities exist between the fairness proposal and fraudulent conveyance law in the distressed company context, significant differences illustrate the unique value of the fairness proposal. For example, the fairness proposal contemplates a more comprehensive review of a broader range of transactions that considers not only fair value but also whether the board employed a fair process in considering the transaction. See supra Part V.C. It also seeks to protect corporate value on an ex ante rather than ex post basis. See, e.g., discussion of statute of limitations and market test supra Part VI.C.1. In addition, the fairness proposal does not depend on a corporation’s financial condition.

239 See, e.g., Burch, supra note 207, at 550 (discussing concern of increased director liability and retaining qualified individuals to serve as directors in the context of increased judicial scrutiny of directors’ decisions); A. Mechele Dickerson, Courting Failure? The Effects of Venue Choice on Big Bankruptcies, 54 BUFF. L. REV. 365, 398 (2006) (same); Bernard Black et al., Outside Director Liability, 58 STAN. L. REV. 1055, 1059 (2006) (same).
lead to “carrot” or “stick” proposals to encourage good corporate governance.\footnote{240}{See, e.g., Lynn A. Stout, On the Proper Motives of Corporate Directors (or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. L. 1 (2003) (discussing the “carrot” (i.e., reward) and “stick” (i.e., penalty) approaches to corporate governance).}

The fairness proposal suggests the use of sticks to enhance board review of, and better protect corporations from abuse in, controlled transactions.\footnote{241}{See supra Part VI.C.1; see also Lisa M. Fairfax, Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability, 42 Hous. L. Rev. 393, 451 (2005) (discussing increased director liability and positing that “because alternative measures have proved insufficient to deter director laxity, the corporate governance system must rely on legal sanctions and therefore must bear the cost associated with those sanctions”).} The proposal places the burden of proof to establish the fairness of any stakeholder transaction on the board. Failure to meet this burden would subject the board to liability for a breach of the duty of loyalty. Studies show that independent directors face an increased potential for paying out-of-pocket damages in controlled transaction and breach of the duty of loyalty cases.\footnote{242}{See Black et al., supra note 239, at 1090 (“Our data on trials indicate that the primary area in which outside directors of public companies face duty of loyalty claims is not where they have enriched themselves, but rather where they have favored a controlling shareholder—or sometimes the CEO or other inside manager - over minority shareholders.”) (citing Robert B. Thompson & Randall S. Thomas, The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions, 57 Vand. L. Rev. 133 (2004) (study reaching similar conclusion)).} Moreover, the board could mitigate potential liability under the fairness proposal by taking appropriate steps, including requiring full disclosure of potential conflicts, exploring reasonably available alternatives to the controlled transaction, consulting with experts and professionals

The board’s potential exposure to real liability in controlled transactions under the fairness proposal may have the desired effect of reducing board passivity and curbing abuse in controlled transactions. This same threat of exposure, however, may cause qualified individuals to decline board appointments.\footnote{243}{Id. at 1059 (positing that “beyond some level of liability risk, qualified people may decide not to serve as directors and that those who do serve may become excessively cautious”).} Although the proposal may deter some board candidates, the benefits of board service likely would outweigh any increased risk for most candidates.\footnote{244}{See Burch, supra note 207, at 550–51 (discussing fears regarding director service following Smith v. Van Gorkom and noting that “although there was a decrease in the number of qualified directors who continued to serve, the decrease was temporary”); Fairfax, supra note 241, at 451–53 (discussing fears after Enron and enactment of the Sarbanes-Oxley Act).}
regarding the proposed transaction and disclosing the transaction in a timely manner.\textsuperscript{245}

D. The Risk of Increased Litigation

An argument could be made that stripping the board of business judgment protection in controlled transactions will open the litigation floodgates. Placing the burden to show the fairness of the transaction on the board may make it more difficult for the board to succeed on a motion to dismiss the litigation.\textsuperscript{246} As suggested above, however, the real threat of litigation and resulting liability may not be a complete negative.\textsuperscript{247} That threat may be what is necessary to encourage boards to be more than passive participants in controlled transactions.

In addition, the fairness proposal contemplates a short statute of limitations and incorporates concepts of unique benefit and economic injury to act as safety valves against strike suits.\textsuperscript{248} A stakeholder transaction would exist only if the plaintiff timely alleged specific facts showing a transaction that involved and provided a unique benefit to an existing stakeholder and that injured the corporation.\textsuperscript{249} Absent sufficient allegations, the presumption of board conflict would not apply and the business judgment rule may be available to protect the board’s decision.\textsuperscript{250}

VIII. Conclusion

Transactions between a corporation and one or more of its stakeholders are not a new phenomenon. Likewise, the potential for abuse in these transactions is a time-tested truth. The law historically has governed these transactions

\begin{footnotesize}
\begin{enumerate}
\item See supra Part VI.C.1. See also, e.g., Elizabeth A. Nowicki, \textit{Not in Good Faith}, 60 SMU L. Rev. 441, 484–90 (2007) (explaining potential actions by board to mitigate increased liability risks); Mark J. Loewenstein, \textit{The Quiet Transformation of Corporate Law}, 57 SMU L. Rev. 353, 379 (2004) (“The decision of whether to serve on a corporate board is influenced not only by the potential liability, or costs, of service, but also by potential rewards.”). In addition, directors would be entitled to indemnification for expenses incurred in any litigation under most state corporate codes, provided that no finding of liability is made against the directors. See, e.g., 8 Del. C. § 145.
\item See, e.g., Pritchard, \textit{supra} note 101, at 89 (noting that “application of the entire fairness standard, even if the controlling shareholder was likely to eventually prevail, ‘normally will preclude dismissal of a complaint on a Rule 12(b)(6) motion to dismiss’”).
\item See supra Part VII.C.
\item See supra Part VI.C.1.
\item Id.
\item Likewise, if a stakeholder transaction does not exist, the plaintiff would be required to show lack of board disinterestedness or independence or grounds to rebut the business judgment presumption in order to file a derivative lawsuit against the board without demand. See \textit{supra} Part VI.C.1.
\end{enumerate}
\end{footnotesize}
by treating controlling stakeholders as fiduciaries in their dealings with the corporation. Nevertheless, the fiduciary label does not accurately describe the relationship between stakeholders and the corporation, and the increasing control exerted by activist stakeholders further strains this analogy.251

A corporation’s stakeholders, whether shareholders, lenders, bondholders or customers, often possess similar rights with respect to the corporation and invoke these rights to protect or enhance their corporate investment and contract rights.252 These stakeholders generally do not purchase the stock or the debt of the corporation to benefit the corporation or other stakeholders; self-interest is inherent in all aspects of their dealings with the corporation. Consequently, imposing fiduciary duties on, and demanding undivided loyalty from, these stakeholders is an unsatisfactory solution in most cases.

On the other hand, the board owes an undivided duty of loyalty to the corporation and is better suited to protect the corporation’s interest in controlled transactions.253 The board’s vantage point and resources allow it to identify potential stakeholder self-dealing and more objectively evaluate the corporation’s alternatives. Yet as business relations become more complex and stakeholders develop new and innovative ways to influence corporate affairs, the board may cede power to the interested stakeholder to the corporation’s detriment. Moreover, the board’s decision may be protected by the business judgment rule and the transaction may never receive the close scrutiny it deserves.

Courts and policymakers need to reassess the potential for abuse in controlled transactions, particularly in light of the increased activism by hedge funds, private equity firms and other institutional investors. The dynamics between boards and controlling stakeholders are changing; the law governing controlled transactions must adapt and encourage meaningful ex ante review of any transaction potentially favoring the interests of certain stakeholders. The fairness proposal provides that structure by requiring boards to more closely monitor and filter controlled transactions, pursuing those that enhance corporate value and rejecting those that do not.

———

251 See supra Part V.C.1.
252 See supra Part IV.
253 See supra Part VI.
Corporate boards are in the best position to govern controlled transactions. They should not be permitted to shirk this responsibility under the guise of the business judgment rule. The fairness proposal calls upon boards to demonstrate the fairness of any stakeholder transactions they approve. Although this approach may initially entice plaintiffs’ lawyers to file more lawsuits, it should not result in any increased liability for boards complying with their existing fiduciary duties. Boards should be exposing controlled transactions to intense scrutiny and, where appropriate, meaningful market tests. The fairness proposal requires nothing more. Board resistance to the heightened scrutiny imposed under the fairness proposal may only suggest that a closer look is in fact needed.