CURBING RENT-SEEKING BY ACTIVIST SHAREHOLDERS: THE BRITISH APPROACH

*David W. Giattino**

I. INTRODUCTION

During the 1980s, activist shareholders abused their positions in public corporations by purchasing sufficient shares of the corporation to threaten a hostile takeover and then having the corporation buy back the shares at a premium to thwart the takeover, a practice known as extracting "greenmail."[1] In one case, Sir James Goldsmith[2] extracted $90 million in greenmail from the Goodyear Tire and Rubber Company.[3] Today, the federal government discourages such behavior by imposing a fifty-percent excise tax on greenmail.[4]

Economists refer to extracting greenmail and related behaviors as "rent-seeking," which "is the socially costly pursuit of wealth transfers."[5] Thus, successful rent-seeking results in a wealth transfer. A wealth transfer furnishes one party (a "transferee") with an economic gain at the expense of another (a "transferor").[6] In fact, the economic gain enjoyed by a transferee must equal the

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* Managing Editor, The Temple International and Comparative Law Journal; J.D., The Temple University James E. Beasley School of Law; Honors B.S. with Distinction in Economics with a Minor in Mathematics, The University of Delaware; Honors B.A. in Political Science with a Minor in History. The Author wrote this Article in memory of the his mother, Bonnie F. Giattino, and his grandparents, Morris and Eva Feurstein.

1. *See* BLACK'S LAW DICTIONARY 770 (9th ed. 2009) (defining "greenmail").

2. The character "Sir Lawrence Wildman," from the movie *Wall Street*, is reportedly based upon Sir James Goldsmith. Simon Goodley, *Brace Yourself, Gekko is Back*, DAILY TELEGRAPH (LONDON), Aug. 28, 2007, at 3.

3. MARTIN TOLCHIN & SUSAN TOLCHIN, BUYING INTO AMERICA 244 (1988); Anthony Bianco et al., *A Flurry of Greenmail Has Stockholders Cursing*, BUS. WK., Dec. 8, 1986, at 32.

4. 26 U.S.C. § 5881(a) (2006) ("There is hereby imposed on any person who received greenmail a tax equal to 50 percent of gain or other income of such person by reason of such receipt.").

5. Robert D. Tollison, *Rent Seeking*, *in* PERSPECTIVES ON PUBLIC CHOICE: A HANDBOOK 506 (Dennis C. Mueller ed., 1997); *see also* PAUL R. MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 270 (1992) ("Activities that serve no social function other than to transfer rents . . . have been called *rent seeking* . . . ." (emphasis in original)). Gordon Tullock first observed the phenomenon of rent-seeking. *See* Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967). However, Anne Krueger coined the term "rent-seeking" to describe the phenomenon. *See* Ann Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291 (1974). For an introductory explanation of rent-seeking, see WILLIAM J. BAUMOL & ALAN S. BLINDER, ECONOMICS: PRINCIPLES AND POLICY 248 (9th ed. 2003).

6. *See* Lynn A. Stout, *Some Thoughts on Poverty and Failure in the Market for Children's Human Capital*, 81 GEO. L. J. 1945, 1946 n.7 (1993) ("Wealth transfers by definition do not increase the overall level of wealth enjoyed by a society, as any wealth increase enjoyed by the

economic loss imposed upon a transferor.[7] Therefore, a rent-seeker endeavors to obtain wealth without contributing to wealth creation.

Rent-seeking gives rise to two additional costs beyond the cost to the transferor.[8] First, it wastes the resources expended by rent-seeking.[9] Second, rent-seeking distorts the corporate decision-making process, thereby generating influence costs.[10] The wasted resources and influence costs constitute the social costs of rent-seeking.[11] In all, because rent-seeking creates no wealth, its total costs are, at least, equal to its total benefits. Today, rent-seeking behavior other than greenmail remains unimpeded by state corporation law, thereby inviting another federal intervention.

For example, assume an activist shareholder, the Kalamazoo Public Employees' Retirement System ("KalPERS"), owns five percent of the common stock of a struggling corporation with a poor safety record, Oceanic Airlines. To increase share price, KalPERS urges Oceanic's management to sell the corporation. Eventually, a fledging corporation, Blue Star Airlines, expresses interest in acquiring Oceanic. However, Blue Star's management worries that the premium over share price of acquiring Oceanic is too great. Thereafter, KalPERS springs into action, by purchasing a five percent holding of Blue Star's common stock. Concurrently, KalPERS hedges away its economic interest in Blue Star by purchasing derivative contracts and other securities, but maintains the legal rights associated with the ownership of common stock. Thus, KalPERS will not bear the economic costs of any decline in the price of Blue Star's common stock. Next, KalPERS approaches Blue Star's Board of Directors and threatens a proxy battle and litigation unless the Board consummates the acquisition of Oceanic. In the end, KalPERS hopes to secure the premium over share price at the expense of Blue Star and its other shareholders.

There are numerous other examples of rent-seeking by activist shareholders.[12] Such behavior remains unhindered by state corporation law because of the assumptions developed at the beginning of the twentieth century.

In 1932, Adolf Berle and Gardiner Means initiated the modern era of corporate governance when they published *The Modern Corporation and Private Property*.[13] In this seminal text, Berle and Means demonstrated that public

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transferee must be matched by a wealth loss by the transferor.").

7. *Id.*

8. MILGROM & ROBERTS, *supra* note 5, at 270.

9. *Id.*

10. *Id.*

11. A "social cost" is one society incurs due to a behavior, practice, or rule. BLACK'S LAW DICTIONARY 398 (9th ed. 2009).

12. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1258-60 (2008).

13. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed., Harcourt, Brace & World, Inc. 1967) (1932); Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J. L. & PUB. POL'Y 671, 671 (1995) ("The 1932 publication of Berle and Means's THE MODERN CORPORATION AND PRIVATE PROPERTY began the modern era of corporate governance scholarship"); *see also* Dalia Tsuk Mitchell, *Status*

corporations are characterized by a separation of ownership and control.[14] Under the Berle and Means model of separation, the shareholders of public corporations exercise minimal to no control over corporate business and affairs.[15] Instead, the managers of public corporations exercise near-complete dominion over such matters.[16]

Since 1932, the legislatures and judiciaries of the several states have incorporated this theory of separation of ownership and control into the law.[17] Because state corporation law presumes that shareholders lack the power to manage a corporation's business and affairs, the law does not regulate the exercise of shareholder power unless extraordinary circumstances are present.

However, recent developments have eroded the wall that once separated ownership and control of public corporations. Berle and Means asserted that the separation of ownership and control arose from "the multiplication of owners."[18] In modern parlance, the separation is a consequence of dispersed ownership.[19]

Bound: The Twentieth Century Evolution of Directors' Liability, 5 N.Y.U. J. L. & BUS. 63, 87 (2009) (describing Berle and Means' THE MODERN CORPORATION AND PRIVATE PROPERTY as "the 'ur-text' of modern corporate governance").

14. *See* BERLE & MEANS, *supra* note 13, at 3-10.

15. BERLE & MEANS, *supra* note 13, at 78; Joseph W. Yockey, *On the Role and Regulation of Private Negotiations in Governance*, 61 S.C. L. REV. 171, 176-77 (2009) ("Since original described by Berle and Means, the separation of ownership and control that characterizes the modern public corporation contemplates a governance arrangement whereby shareholders exercise virtually no control over the operations and objectives of the firms in which they have invested.").

16. BERLE & MEANS, *supra* note 13, at 5; Harwell Wells, *"No Man can be Worth $1,000,000 a Year": The Fight over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 691 (2010) ("Berle and Means argued that as legal ownership of America's largest corporations shifted to small shareholders dispersed across the nation, real control of those firms accrued to the corporations' managers, individuals who owned little of the property they commanded."); Yockey, *supra* 16, at 177 ("Instead, control is vested in the board o6f directors and those executives and managers selected by the board to oversee day-to-day operations."); Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1351 ("According to the Berle-Means framework, managers hold few shares but exercise substantial control over their firms.").

17. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (West 2009) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."); MODEL BUS. CORP. ACT § 8.01(b) (LexisNexis, current through 2007 edition) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors . . . ."); Jana Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335, 340 (Del. Ch. 2008) ("At the heart of the corporate form lies the fundamental principle of separation of ownership and management.").

18. BERLE & MEANS, *supra* note 13, at 5 ("[A] large measure of separation of ownership and control has taken place through the multiplication of owners.").

19. Arthur R. Pinto, *The European Union's Shareholder Voting Rights Directive from an American Perspective: Some Comparisons and Observations*, 32 FORDHAM INT'L L.J. 587, 616 (2009) ("[T]he U.S. publicly traded corporation is characterized as having . . . widely dispersed ownership resulting in the separation of ownership from control."); Gregory A. Mark, *Realms of Choice: Finance Capitalism and Corporate Governance*, 95 COLUM. L. REV. 969, 974 (1995)

Moreover, Berle and Means considered the dispersion of ownership as "inherent in the corporate system."[20] Today, institutional investors, like KalPERS in the earlier example, challenge the principle that dispersion of ownership is inherent in the corporate system.[21]

Institutional investors present another challenge to the dispersion of ownership principle. An institutional investor "trades large volumes of securities, usually by investing other people's money into large managed funds."[22] Institutional investors include pension funds, mutual funds, hedge funds, bank trusts, insurance companies, endowments, and foundations.[23] Because of the substantial resources available to institutional investors,[24] they can amass considerable holdings in public corporations and, consequently, concentrate ownership.[25] Thus, institutional investors are anathema to dispersion of ownership and, hence, the separation of ownership and control.[26]

By acquiring a significant ownership stake in a public corporation, an institutional investor can garner influence over the business and affairs of the corporation.[27] Then, the institutional investor can use its influence to compel management to act in the best interests of the corporation, its shareholders, and the institutional investor itself.[28] However, the institutional investor could use its

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(book review) (citing MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 256 (1994)) ("On the other hand, that same separation results from widely dispersed ownership which has given America's capital market a flexibility and an openness to funding entrepreneurial ventures unknown elsewhere").

20. BERLE & MEANS, *supra* note 13, at 47 ("Dispersion in the ownership of separate enterprises appears to be inherent in the corporate system.").

21. *See* Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 477 (2008) ("[W]ith the rise of institutional investors, the diffusion of stock ownership has reversed course.").

22. BLACK'S LAW DICTIONARY 904 (9th ed. 2009).

23. *Id.*; MICHAEL J. RUBACH, INSTITUTIONAL SHAREHOLDER ACTIVISM: THE CHANGING FACE OF CORPORATE OWNERSHIP 1 (Stuart Bruchey ed., 1999).

24. For example, as of July 31, 2009, the market value of the California Public Employees' Retirement System's ("CalPERS") investment portfolio is $231.4 billion. CALPERS, FACTS AT A GLANCE: INVESTMENT, MAY 2011 (2009), *available at* http://www.calpers.ca.gov/eip-docs/about/facts/investments.pdf.

25. *See* Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy*, 2007 B.Y.U. L. REV. 1, 48 (2007) (describing institutional investors as "holders of large blocks of stock").

26. *See* Bainbridge, *supra* note 13, at 671 ("If [institutional investors] had arisen along side the large industrial corporations, ownership and control might not have separated or at least not to the degree present in the Berle-Means corporation").

27. *See* THOMAS CLARKE, INTERNATIONAL CORPORATE GOVERNANCE: A COMPARATIVE APPROACH 92 (2007) ("As institutional invested came to own the majority of shares in most large corporations, this qualified the Berle and Means model of the publicly held corporation with widely diffused shareholders, and though the leaders of the institutional investors rarely exercised their potential power, certainly their influence exercised a degree of restraint on most corporate executives").

28. *See* Alicia Davis Evans, *A Requiem for the Retail Investor*, 95 VA. L. REV. 1105, 1114 (2009) ("[I]institutional investors can use their market power to persuade corporations to act appropriately."); Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J.

influence "not only to enhance shareholder value[,] but also to obtain private benefits."[29] Conceivably, an institutional investor could wield its influence to acquire private benefits at the expense of other shareholders – classic rent-seeking behavior.[30]

Because activist shareholders, specifically institutional investors, can accumulate power over the business and affairs of the corporation, state corporation law *should* impose commensurate responsibilities upon activist shareholders. However, U.S. jurisdictions continue to lack sufficient safeguards against rent-seeking by activist shareholders.

Given the continuing existence of rent-seeking, this article will (1) identify the mechanisms utilized to curb rent-seeking by activist shareholders under the corporation law of Britain and (2) discuss the potential application of those mechanisms in U.S. jurisdictions. Specifically, this article contends that U.S. jurisdictions should subject activist shareholders, even those without a controlling stake, to fiduciary duties. First, the article will analyze current restrictions on rent-seeking behavior by activist shareholders. Second, the article will survey the U.K.'s Companies Act of 2006 to identify mechanisms that limit rent-seeking by activist shareholders. Finally, based upon the survey of the Companies Act of 2006, the article will provide prescriptions against rent-seeking by activist shareholders that can be employed in U.S. jurisdictions.

II. THE DELAWARE GENERAL CORPORATION LAW

Generally, the law of corporations imposes no obligations upon owners of common stock.[31] However, in limited circumstances, the law does impose fiduciary duties upon shareholders.[32] Because courts and scholars usually analyze fiduciary duties with respect to directors, this article begins with a discussion of corporate directors' fiduciary duties before turning to a discussion of both the fiduciary duties of shareholders and the present deficiencies in those duties. Moreover, because Delaware is the dominant forum for incorporation,[33] the article

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CORP. L. 409, 425 (2009) ("[I]nstitutional investors . . . not only have enough stock to have a controlling influence, they also have business and financial incentives to be critical shareholders looking out for the corporation's best interest.").

29. Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 574 (2006).

30. *Id.* ("Shareholders with private interests, however, might prefer the firm to pursue those interests at the expense of the interests they have in common with other shareholders").

31. JEFFREY D. BAUMAN ET AL., CORPORATIONS: LAW AND POLICY 36 (6th ed., 2007) (noting that "[a]lthough directors owe fiduciary duties, shareholders generally do not"); WILLIAM MEADE FLETCHER, THE FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5713 (rev. ed. 2000) ("Ordinarily . . . [a shareholder] has no well-defined duties").

32. ROBERT C. CLARK, CORPORATE LAW 141 (1986) ("Directors, officers, and, in some situations, controlling shareholders owe . . . a fiduciary duty of loyalty"); Anabtawi & Stout, *supra* note 12, at 1265 ("In some cases, however, courts impose fiduciary duties of loyalty on certainly types of shareholders as well").

33. Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study*

will discuss fiduciary duties as defined by Delaware law.

A. The Fiduciary Duties of Corporate Directors[34]

Under Delaware law, corporate shareholders delegate the authority to manage and direct the corporation's business and affairs to its board of directors.[35] In return, the directors stand in a quasi-trustee and agency relationship with the corporation and its shareholders.[36] Moreover, as quasi-trustees, the directors stand in a fiduciary relationship with and owe fiduciary duties to the corporation and its shareholders.[37] Specifically, corporate directors owe independent duties of care and loyalty,[38] as well as non-independent duties including good faith,[39] oversight,[40] and

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of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts, 30 CARDOZO L. REV. 1475, 1498 (2009) (empirically confirming "Delaware's dominance as a place of incorporation for publicly held firms").

34. The same fiduciary duties that apply to corporate directors also apply to corporate officers. Gantler v. Stephens, 965 A.2d 695, 708-09 (Del. 2009).

35. DEL. CODE ANN. tit. 8, § 141(a) (West 2009) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than stockholders, manage the business and affairs of the corporation"); *In re* Am. Int'l Group, Inc., 965 A.2d 763, 807 (Del. 2009) ("Under Delaware law, the directors, rather than the stockholders, are empowered to manage a corporation").

36. Schoon v. Smith, 953 A.2d 196, 206 (Del. 2008) (The fiduciary "duties stem in part from the quasi-trustee and agency relationship directors have to the corporation and stockholders that they serve"); *In re* Show-Town, Inc. Stockholders Litig., Civ. A. No. 9483, 1990 WL 13475, at 7 (Del. Ch. Feb. 12, 1990), *reprinted in* 16 DEL. J. CORP. L. 404, 417 (1991) ("Directors and other governing members of a corporation who are imbued with fiduciary responsibility can be characterized as agents and quasi trustees"); *see also* Gottlieb v. McKee, 107 A.2d 240, 243 (Del. 1954) ("While technically not trustees, [directors] stand in a fiduciary relation to the corporation and its stockholders."); Bodell v. Gen. Gas & Elec. Corp., 132 A. 442, 446 (Del. 1926) ("While [directors] are not trustees in the strict sense of the term, yet for convenience they have often been described as such.").

37. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("While technically not trustees, [directors] stand in a fiduciary relation to the corporation and its stockholders"); *see also* Official Comm. Of Unsecured Creditors of Fedders, N. Am., Inc. v. Goldman Sachs Credit Partners, L.P. (*In re* Fedders N. Am., Inc.), 405 B.R. 527, 539 (Bankr. D. Del. 2009) (citing Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998)) ("The Delaware Supreme Court recognized long ago that where there is a separation of legal control from beneficial ownership, equity imposes fiduciary duties upon those in control to protect the beneficiaries who are not in a position to protect themselves").

38. *Schoon* , 953 A.2d at 206 (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("In discharging their management function, "directors owe fiduciary duties of care and loyalty to the corporation and its shareholders"); *see also Malone*, 722 A.2d at 10 (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)) ("The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty.").

39. *See Malone*, 722 A.2d at 10 (citing *Cede & Co.*, 634 A.2d at 361 (Del. 1993)) ("The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty"); Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[A]lthough good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not

disclosure.[41] However, the business judgment rule heavily modifies and tempers the fiduciary duty of corporate directors.

1. The Business Judgment Rule

The business judgment rule establishes the legal presumption that, in making a business decision, the directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[42] When applying the business judgment rule, a court will not disturb the judgment of a board of directors if its decision can be ascribed to any rational business purpose.[43] For this reason, to rebut the presumption established by the business judgment rule, a plaintiff must demonstrate that the directors breached either their fiduciary duty of loyalty or their fiduciary duty of care, either directly or through subsidiary duties such as the duties of good faith, oversight, and disclosure.[44]

2. The Fiduciary Duty of Care

Under Delaware law, the fiduciary duty of care[45] requires corporate directors, in managing the business and affairs of the corporation, "to use that amount of care

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establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.").

40. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (establishing a duty of oversight); *see also Stone*, 911 A.2d at 370 ("It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty"); Beam v. Stewart, 833 A.2d 961, 971 n.16 (Del. Ch. 2003) ("The 'duty to monitor' is not a separate fiduciary duty, but rather stems from the core fiduciary duties of care and loyalty").

41. Jackson Nat'l Life Ins. Co. v. Kennedy, 741 A.2d 377, 387 (Del. Ch. 1999) ("[I]t is true that the directors of a Delaware corporation owe a fiduciary 'duty of disclosure' to its stockholders when they seek stockholder action"); *see also* Malpiede v. Townson, 780 A.2d 1075, 1086 (Del. 2001) ("[T]he board's fiduciary duty of disclosure . . . is not an independent dut[y] but the application in a specific context of the board's fiduciary duties of care, good faith, and loyalty"); *Malone*, 722 A.2d at 11 (Del. 1998) ("The duty of directors to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty, and good faith").

42. *Aronson*, 473 A.2d at 812; *accord* McMullin v. Beran, 765 A.2d 910, 916 (Del. 2000); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (Del. Ch. 2009).

43. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)) ("A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose'"); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 928 (Del. 2003).

44. *Cede & Co.*, 634 A.2d at 361 (Del. 1993) ("To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty-good faith, loyalty or due care."); *accord* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000); Citron v. Fairchild Camera and Instrument Corp., 569 A.2d 53, 64 (Del. 1989).

45. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.15 (3d ed., 1997).

which ordinarily careful and prudent men would use in similar circumstances."[46] However, the conduct of corporate directors is reviewed for gross negligence, not ordinary negligence.[47] That is, in light of the policy considerations of the business judgment rule, the standard of review has diverged from the standard of conduct.[48] Thus, while the standard of conduct remains ordinary negligence, the standard of review applied by Delaware courts is gross negligence.[49]

Therefore, corporate directors' liability for breaches of the duty of care "is predicated upon concepts of gross negligence."[50] Moreover, because these concepts "import[] the concept of recklessness,"[51] a corporate director only violates the fiduciary duty of care if his conduct "constitute[s] reckless indifference" or is "without the bounds of reason."[52] This gives directors significantly more leeway than they would have under a concept of ordinary negligence.

Next, under Delaware law, the fiduciary duty of care requires that corporate directors "inform[] themselves 'prior to making a business decision, of all material information reasonably available to them.'"[53] In *Smith v. Van Gorkom* (Trans Union Case), the Delaware Supreme Court held that the directors of Trans Union were grossly negligent and breached their fiduciary duty of care because they approved a cash-out merger without becoming informed of all material information reasonably available to them.[54] The Delaware Supreme Court based this influential judgment upon several facts:

(1) The directors never read a copy of the merger agreement;
(2) The directors never asked for a fair market valuation of Trans Union

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46. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); *accord In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27, 64, 66 (Del. 2006).

47. *Aronson*, 473 A.2d at 812 ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence"); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d at 124 (applying the standard from *Aronson*); ; Miller v. Greystone Bus. Credit II, L.L.C. (*In re* USA Detergents, Inc.), 418 B.R. 533, 543-544 (Bankr. D. Del. 2009).

48. William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 451-53 (2002); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 437-38 (1993).

49. Allen, *supra* note 48, at 451-53; Eisenberg, *supra* note 48, at 437-38.

50. *Aronson*, 473 A.2d at 812 (Del. 1984); *accord In re Citigroup*, 964 A.2d at 124.

51. *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 652, 652 n.45 (Del. Ch. 2008); *see also* Tomczak v. Morton Thiokol, Inc., Civ. A. No. 7861, 1990 WL 42607, at * 12 (Del. Ch. 1990), *reprinted in* 16 DEL. J. CORP. L. 924, 946 (1991) ("In the corporate context, gross negligence means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.").

52. McPadden v. Sidhu, 964 A.2d 1262, 1274 (Del. Ch. 2008); *accord* Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 192 (Del. Ch. 2005), *aff'd*, 906 A.2d 114 (Del. 2006); *Tomczak*, 16 DEL. J. CORP. L. at 946.

53. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson*, 473 A.2d at 812); *accord In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 368 (Del. Ch. 2008).

54. *Smith*, 488 A.2d at 893 (Del. 1985).

or a fairness opinion by an investment banker;

(3) There was no advance notice of the purpose of the meeting;

(4) There was no crisis, emergency, or other exigency; and

(5) The directors based their decision only upon a 20-minute presentation by the CEO and a statement by the CFO that the price was fair.[55]

In the aftermath of the Trans Union Case, many qualified individuals refused to serve as corporate directors.[56] The Trans Union Case reshaped Delaware corporate fiduciary law – but the backlash forced re-entrenchment.

In response to the Trans Union Case, the Delaware General Assembly enacted section 102(b)(7) of the Delaware General Corporation Law (DGCL).[57] Under section 102(b)(7), a corporation may exculpate its directors from personal liability for breaches of the fiduciary duty of care.[58] Section 102(b)(7) joined another director-friendly provision – section 145(a) of the DGCL. Under section 145(a), a corporation may indemnify its directors for any liability arising from their service as directors, provided that the directors act in good faith and reasonably believe that their actions are in the best interests of the corporation.[59]

Despite the holding in the Trans Union Case, corporate directors are now rarely personally liable or otherwise financially responsible for breaches of their fiduciary duty of care because of exculpation under section 102(b)(7), indemnification under section 145(a), and the gross negligence standard of review.[60]

3. The Fiduciary Duty of Loyalty

Under Delaware law, "[t]he rule that requires an undivided and unselfish loyalty to the corporation," the duty of loyalty,[61] "demands that there shall be no

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55. *Id.* at 874.

56. R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporation*, 12 DEL. J. CORP. L. 5, 9 (1987).

57. Malpiede, 780 A.2d at 1095 ("Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*").

58. DEL. CODE ANN. tit. 8, § 102(b)(7) (2009); *see also Malpiede*, 780 A.2d at 1095 (applying section 102(b)(7)). However, a corporation may *not* exculpate its directors for violations of the duties of loyalty and good faith. DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (2009).

59. DEL. CODE ANN. tit. 8, § 145(a) (2009).

60. *In re Walt Disney*, 907 A.2d at 750 ("Because duty of care violations are actionable only if the directors acted with gross negligence, and because in most instances money damages are unavailable to a plaintiff who could theoretically prove a duty of care violation, duty of care violations are rarely found"), *aff'd*, 906 A.2d 27, 35 (Del. 2006); Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L 393, 403 (2007) ("[D]irectors of Delaware corporations are generally not liable for breaching their duty of care . . . .").

61. *Guth*, 5 A.2d at 510. For an in-depth discussion of the fiduciary duty of loyalty under Delaware law, see Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 683-91 (2009).

conflict between duty and self-interest."[62] That is, "the fiduciary duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director . . . and not shared by the stockholders generally."[63] The "[c]lassic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally."[64]

Consequently, a corporate director may not "derive any personal financial benefit" through self-dealing.[65] A corporate director engages in self-dealing where the director has (1) "a personal financial stake antithetic to the corporate interest in a corporate transactions or proposed course of action," or (2) "some material direct or indirect financial stake in an entity which is contracting or transacting business with, or receiving benefits from, the corporation."[66] Self-dealing is the prototypical example of conduct that impinges upon the fiduciary duty of loyalty.[67] However, other behavior also runs afoul of this duty, including "receiving a personal benefit from a transaction not received by the shareholders generally."[68]

Notably, this duty is qualified. A corporate director *may* violate the fiduciary duty of loyalty where the director receives a personal benefit in an otherwise arms-length transaction.[69] But the duty is only violated if the personal benefit is "material."[70] Under the subjective "actual person" analysis, a personal benefit is "material" if a director "in fact was or would likely be affected" by the benefit.[71] This means that a plaintiff only establishes a breach of the fiduciary duty of loyalty if he is able to demonstrate either self-dealing or a "material" personal benefit to the director.

Ordinarily, demonstrating a breach of the fiduciary duty of loyalty rebuts the director-friendly business judgment rule.[72] However, Delaware common law

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62. *Guth*, 5 A.2d at 510; *accord Schoon*, 953 A.2d at 206; *Cede & Co.*, 634 A.2d at 361; Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

63. *Cede & Co.*, 634 A.2d at 361; *accord Benihana*, 891 A.2d at 191.

64. *Cede & Co.*, 634 A.2d at 362 (citing, *inter alia*, Nixon v. Blackwell, 626 A.2d 1366, 1375 (Del. 1993)).

65. *Aronson*, 473 A.2d at 812; *accord* Williams v. Geier, 671 A.2d 1368, 1377 n.19 (Del. 1996); and *In re Transkaryotic*, 954 A.2d at 364).

66. DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 15.05[1] (Mathew Bender & Co., Inc., LexisNexis current through 2009).

67. Deborah A. Demott, *Trust and Tension within Corporations*, 81 CORNELL L. REV. 1308, 1333 (1996) (book review).

68. *Cede & Co*. 634 A.2d at 362 (citing, *inter alia*, *Nixon*, 626 A.2d at1375).

69. *Id.*; HMG/Courtland Properties, Inc. v. Gray, 749 A.2d 94, 113 (Del. Ch. 1999); DAVID A. DREXLER ET AL., *supra* note 66, at § 15.05[1].

70. *Cede & Co*., 634 A.2d at 362; *HMG/Courtland Properties, Inc.*, 749 A.2d at 113; DAVID A. DREXLER ET AL., *supra* note 66, at § 15.05[1].

71. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1151 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

72. *Cede & Co.*, 634 A.2d at 361 ("To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care"); *In re* ALH Holdings

provides safe harbors for interested transactions.[73] These common law safe harbors are related and similar to the safe harbor provisions of section 144(a) of the DGCL.[74] Under Delaware law, an interested corporate director reclaims the benefits of the business judgment rule if a disinterested majority of the *entire* board of directors approved the interested transaction[75] or a majority of the disinterested, outstanding shares voted to ratify the interested transaction.[76] Thus, the identity of the applicable standard of review hinges upon whether disinterested directors or shareholders sanctioned the interested transaction in accordance with the law.[77]

Despite the safe harbors for interested directors, the fiduciary duty of loyalty is the primary mechanism constraining the behavior of directors because corporations cannot exculpate breaches of the duty of loyalty under Section 102(b)(7) of the DGCL.[78]

4. The Fiduciary Duty of Good Faith

Under Delaware law, the fiduciary duty of good faith[79] "'is a subsidiary element[,]' of the fundamental duty of loyalty,'" *i.e.*, a breach of the duty of good faith "is not conduct that results, *ipso facto*, in the direct imposition of fiduciary

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LLC, 675 F. Supp. 2d 462, 477 (D. Del. 2009).

73. *See In re* Cox Comm., Inc. S'holders Litig., 879 A.2d 604, 615 (Del. Ch. 2005) (explaining how directors can reclaim the benefits of the business judgment rule under the common law).

74. *See id.* ("[T]he common law of corporations also was centered on the idea of the business judgment rule and its approach to interested transactions look much like that codified in § 144.").

75. BALOTTI & FINKELSTEIN, *supra* note 45, at § 4.16[A]; Blake Rohrbacher et al., *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 737 (2008).

76. *In re* PNB Holding Co. S'holders Litig., Civ. A. No. 28-N, 2006 WL 2403999, at 15 (Del. Ch. 2006), *reprinted in* 32 DEL. J. CORP. L. 654, 677 (2007).

77. A director is "interested" in a corporation transaction if the director violates the fiduciary duty of loyalty. *See In re Transkaryotic*, 954 A.2d at 364 (In *Aronson*, "the Supreme Court defined interest to 'mean that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally'"); Litle v. Waters, Civ. A. No. 12155, 1992 WL 25758, at 4 (Del.Ch. Feb. 11, 1992), *reprinted in* 18 DEL. J. CORP. L. 315, 322 (1993) ("An interested director is one that stands on both sides of a transaction or expects to derive personal financial benefit from the transaction in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."). Moreover, a director is interested if "a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993). In contrast, a director is "disinterested" if the director is *not* interested.

78. *See* DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (2009) (prohibiting exculpation where a director breaches the fiduciary duties of loyalty or good faith).

79. For an in-depth discussion of the fiduciary duty of good faith under Delaware law, *see generally* Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. J. 629 (2010).

liability."[80] Instead, liability for breaching the fiduciary duty of good faith results from a related violation of the fiduciary duty of loyalty. Moreover, "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."[81]

The fiduciary duty of loyalty, through the obligation of good faith, proscribes actions taken in bad faith, including "intentional dereliction of duty . . . [or] conscious disregard of one's responsibilities" and "conduct motivated by an actual intent to do harm."[82] That is, unlike the duty of care, mere gross negligence is insufficient to constitute a breach of the duties of good faith and loyalty,[83] because "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties."[84] Consequently, the duty of good faith is not a perfect substitute for the duty of care, available to circumvent the exculpation provision, section 102(b)(7)), of the DGCL.[85]

5. The Fiduciary Duty of Oversight (or the *Caremark* Claim)

Originally, the fiduciary duty of oversight[86] was an application of the fiduciary duty of care.[87] Today, the fiduciary duty of oversight is an application of the fiduciary duties of loyalty and good faith,[88] as explained in *Stone v. Ritter*.[89]

Under *Stone v. Ritter*, corporate directors breach their *Caremark* duty of oversight where (1) "the director utterly failed to implement any reporting or information system or controls," or (2) "having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[90] In both situations, corporate directors "breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith,"[91] because they "fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their

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80. *Stone*, 911 A.2d at 370 (Del. 2006) (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

81. *Guttman*, 823 A.2d at 506 n.34.

82. *In re Walt Disney*, 906 A.2d at 64; Lyondell Chemical Co. v. Ryan, 970 A.2d 235, 240 (Del. 2009).

83. *In re Walt Disney*, 906 A.2d at 65-66.

84. *Lyondell Chemical*, 970 A.2d at 243.

85. *See In re Walt Disney*, 906 A.2d at 65 ("The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct").

86. For an in-depth discussion of the fiduciary duty of oversight under Delaware law, *see* Stephen M. Bainbridge, et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 582-94 (2008).

87. *In re Caremark* at 971 (Del. Ch. 1996) (establishing a duty of oversight based upon the duty of care).

88. *Stone*, 911 A.2d at 370 ("It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty").

89. *See generally Stone*, 911 A.2d 362.

90. *Id.* at 370.

91. *Id.* (citing *Guttman*, 823 A.2d at 506).

responsibilities"[92] In all, the burden of demonstrating a breach of the fiduciary duty of oversight is high.[93]

6. The Fiduciary Duty of Disclosure

Under Delaware law, corporate directors owe a duty of disclosure.[94] The duty of disclosure requires directors "to disclose fully and fairly all *material* information within the board's control when it seeks shareholder action."[95] In determining whether information is "material," Delaware courts apply the federal standard for materiality:[96]

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.[97]

The test for materiality is objective, measured from the perspective of a reasonable shareholder; this means that "the subjective views of directors . . . as to materiality as to the directors do not control."[98] Consequently, directors must provide the shareholders with "all information which a reasonable shareholder 'would consider important in deciding'" the question at issue.[99]

In addition, because the duty of disclosure is an application of *both* the duties of care and loyalty,[100] some violations of the duty of disclosure cannot be

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

93. *Id.*

94. Jackson Nat'l Life Ins. Co. v. Kennedy, 741 A.2d 377, 388 (Del. Ch. 1999) ("[I]t is true that the directors of a Delaware corporation owe a fiduciary 'duty of disclosure' to its stockholders when they seek stockholder action."). The duty of disclosure is often referred to as the duty of candor. *See Smith*, 488 A.2d at 893 ("For the foregoing reasons, we conclude that the director defendants breached their fiduciary duty of candor by their failure to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval").

95. Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (emphasis added); *In re Transkaryotic*, 954 A.2d at 356; *accord* Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1172 (Del. 2000).

96. *In re Transkaryotic*, 954 A.2d at 356.

97. Rosenblatt v. Getty Oil Co. 493 A.2d 929, 944 (Del. 1985) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

98. BALOTTI & FINKELSTEIN, *supra* note 45, at § 17.10[C].

99. Zirn v. VLI Corp., 621 A.2d 773, 779 (Del. 1993) (quoting *Rosenblatt*, 493 A.2d at 944).

100. *Malpiede*, 780 A.2d at 1086.

exculpated.[101] Therefore, the availability of monetary damages hinges upon which underlying duty was violated:

> A decision violates only the duty of care when the misstatement or omission was made as a result of a director's erroneous judgment with regard to the proper scope and content of disclosure, but was nevertheless made in good faith. Conversely, where there is reason to believe that the board lacked good faith in approving a disclosure, the violation implicates the duty of loyalty.[102]

Thus, a director's violation of the duty of disclosure implicates the duty of loyalty where the director consciously disregards the duty of disclosure *or* the director's "conduct was motivated by an actual intent to do harm."[103]

Furthermore, the duty of disclosure is applicable in the absence of shareholder action. First, directors may not "knowingly disseminate false information that results in corporate injury or damage to an individual stockholder."[104] Second, corporate directors have a duty to disclose information to *other directors*.[105] Ordinarily, this formulation of the duty of disclosure derives from the fiduciary duty of loyalty.[106] It requires "corporate fiduciaries to disclose all material information relevant to corporation decisions from which they may derive a personal benefit."[107] The duty of disclosure demands that directors disclose their interests in corporate decisions and all material information relevant to that decision to the corporate decision-maker, whether the board of directors or shareholder body.

7. The Entire Fairness Standard of Review

If the presumption established by the business judgment rule is rebutted, the corporate director responsible for the challenged transaction must prove the "entire fairness" of the transaction.[108] Under the entire fairness standard of review, the proponent must establish "that the transaction was the product of both fair dealing *and* fair price."[109] That is, a corporate director must demonstrate that the

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101. *See* DEL. CODE ANN. tit. 8, § 102(b)(7)(i)(2009) (prohibiting exculpation where a director breaches the fiduciary duties of loyalty or good faith).

102. *Malpiede*, 780 A.2d at 1086.

103. *In re Walt Disney*, 906 A.2d at 64; *Lyondell Chemical*, 970 A.2d at 240.

104. *Malone*, 722 A.2d at 9; *see also id.* at 14 ("When the directors are not seeking shareholder action, but are deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty").

105. *HMG/Courtland Properties,* 749 A.2d at 119 (holding that directors "had an 'unremitting obligation' to deal candidly with their fellow directors").

106. BALOTTI & FINKELSTEIN, *supra* note 45, at § 4.18.

107. *Mills Acquisition*,559 A.2d at 1280; *see also HMG/Courtland Properties*,749 A.2d at 119.

108. *E.g. Cede & Co.*, 634 A.2d at 361; *Nixon*, 626 A.2d at 1376; *Weinberger*, 457 A.2d at 710; In re Trados Inc. S'holder Litig., Civ. A. No. 1512-CC, 2009 WL 2225958, at 6 (Del. Ch. July 24, 2009).

109. *Cede & Co.*, 634 A.2d at 361 (emphasis in original); *accord Nixon,* 626 A.2d at 1376; *Weinberger*, 457 A.2d at 710; *In re* Sunbelt Beverage Corp. S'holder Litig., Civ. A. No. 16089-CC, 2010 WL 26539, at *5 (Del. Ch. Jan. 5, 2010).

transaction "was on terms as favorable as could have been achieved in an arms-length deal subject to market competition."[110] This assures procedural and substantive fairness.

The entire fairness standard is "sufficiently rigorous that its applicability is sometimes described as outcome determinative."[111] Therefore, corporate directors often seek refuge from the careful scrutiny associated with the standard. Under the common law safe harbors mentioned above,[112] corporate directors may shift the burden onto the plaintiffs, requiring them to prove *unfairness*.[113] Through the entire fairness standard, the courts of Delaware attempt to verify the procedural and substantive fairness of the challenged transaction. Thus, unlike the business judgment rule, the entire fairness standard allows the courts to second-guess the board of directors.

B. The Fiduciary Duties of Shareholders in Public Corporations

Under Delaware law, a shareholder of a public corporation stands in a fiduciary relationship with the corporation and its minority shareholders *only if* the shareholder[114] owns a majority interest in the corporation or exercises actual control of the business and affairs of the corporation.[115]

1. Defining the Term "Controlling Shareholder"

For the purpose of this article, a "controlling shareholder" is one who owns a majority interest in the corporation or exercises actual control of the business and affairs of the corporation. First, the definition is satisfied when a shareholder owns a majority of the corporation's voting shares.[116]

Second, even a minority shareholder can be considered a controlling shareholder if he exercises actual control of the business and affairs of the corporation when, individually or with associates, he can substitute his own judgment for that of the board of directors,[117] or can dictate the composition of the

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110. Strine, *supra* note 79, at 643.

111. *E.g.*, Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 440-41 (2008) (citing AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986)).

112. *See* Part (I)(A)(3).

113. *In re* Walt Disney, 907 A.2d at 747 (citing Solomon v. Armstrong, 747 A.2d 1098, 1111, 1113-17 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000)).

114. For an in-depth discussion of the fiduciary duties of shareholders, *see* Anabtawi & Stout, *supra* note 12, at 1265-74.

115. Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1113-1114 (Del. 1994); Gradient OC Master, Ltd. v. NBC Universal, Inc., 930 A.2d 104, 130 (Del. Ch. 2007).

116. Weinstein Enterprises, Inc. v. Orloff, 970 A.2d 499, 507 (Del. 2005); *Gradient OC Master*, 930 A.2d at 130.

117. *See Kahn*, 638 A.2d at 1114-1115 (finding that "the non-Alcatel [independent] directors deferred to Alcatel because of its position as a significant stockholder and not because they decided in the exercise of their own business judgment that Alcatel's position was correct" supported the legal conclusion that Alcatel was a controlling shareholder subject to fiduciary

board of directors.[118] However, the analysis that the Delaware courts employ to determine whether a minority shareholder is a controlling shareholder is fact-intensive and not easily distilled into a heuristic.[119]

2. The Scope of the Fiduciary Duties of Controlling Shareholders

A controlling shareholder of a public corporation owes fiduciary duties to the corporation and its other shareholders[120] and is entitled to the protections of the business judgment rule.[121] However, according to at least one scholar, the content and boundaries of the fiduciary duties owed by a controlling shareholder to a public corporation and its other shareholders remain unclear.[122] Nonetheless, the courts of Delaware have provided legal guidance.

A controlling shareholder of a public corporation owes at least a limited duty of care to the corporation and its other shareholders.[123] A controlling shareholder implicates its fiduciary duty of care where it has sold its interest to a buyer and knew there was a "risk that the buyer intended to loot or extract illegal rents from the subsidiary, at the expense of the subsidiary's remaining stockholders."[124] Furthermore, some cases have suggested that a controlling shareholder owes the same fiduciary duty of care as corporate directors.[125]

Next, a controlling shareholder of a public corporation owes the same fiduciary duty of loyalty as corporate directors to the corporation and its other shareholders.[126] A controlling shareholder violates its fiduciary duty of loyalty

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duties).

118. *See In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 552 (Del. 2003) (finding that "[Carbonell's] voting power positions him well to elect a new slate [of directors] more to his liking without having to attract much, if any, support from public stockholders" supported the legal conclusion that Carbonell was a controlling shareholder subject to fiduciary duties).

119. *See* Anabtawi & Stout, *supra* note 12, at 1255 ("[W]hen a shareholder has less than a majority stake, courts tend to engage in cautious, detailed factual analysis . . . .").

120. *See* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (1987) ("[A] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation"); *Gradient OC Master*, 930 A.2d at 130 ("Generally, a shareholder owes a fiduciary duty only if it a) owns a majority interest in or b) exercises control over the business affairs of the corporation").

121. *See, e.g., Nixon*, 626 A.2d at 1375-76 (deciding whether to apply the entire fairness standard or the business judgment rule); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720-22 (Del. 1971) (same).

122. Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 HOFSTRA L. REV. 175, 181 (2004); *see also* DREXLER ET AL., *supra* note 66, at § 15.02[2] ("Delaware case law has not expounded at length on the nuances of the controlling stockholders' responsibility").

123. Harris v. Carter, 582 A.2d 222, 235 (Del. Ch. 1990); Abraham v. Emerson Radio Corp., 901 A.2d 751, 762 (Del. Ch. 2006).

124. *Abraham*, 901 A.2d at 762.

125. Pfeffer v. Redstone, 965 A.2d 676, 691 n.52 (Del. 2009); Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 109-10 (Del. 1952); *but c.f. Abraham*, 901 A.2d at 759 (suggesting that § 102(b)(7) provision could exculpate controlling shareholders for breaches of the duty of care under Delaware law, though the Vice Chancellor officially avoided the question).

126. *Pfeffer*, 965 A.2d at 691 n.52; Gentile v. Rossette, 906 A.2d 91, 100 (Del. 2006);

"when the fiduciary duty is accompanied by self-dealing – the situation when a [controlling shareholder] is on both sides of a transaction with [the corporation]."[127] In such circumstances, the courts of Delaware apply careful scrutiny under the entire fairness standard of review.[128]

It is clear that controlling shareholders either owe the same fiduciary duties as corporate directors or there is a trend toward imposing the fiduciary duties of corporate directors upon controlling shareholders.

3. Entire Fairness and Controlling Shareholders

Where a controlling shareholder breaches its fiduciary duties, the controlling shareholder will only avoid liability if he can demonstrate the entire fairness of the challenged transaction or decision.[129] However, like a director, a controlling shareholder may shift the burden to demonstrate the unfairness of the challenged transaction or decision onto the plaintiff if the challenged transaction or decision (1) was approved by an independent committee of disinterested directors[130] or (2) was ratified by a majority of the corporation's non-controlling shareholders.[131] However, under certain circumstances, the courts of Delaware will not shift the burden onto the plaintiff.[132] Thus, the common law safe harbors are less inviting for interested controlling shareholders than for interested directors.

C. The Limitations of Shareholder Fiduciary Duties

Under Delaware law, a shareholder of a public corporation owes fiduciary duties to the corporation and its other shareholders only if the shareholder is a controlling shareholder.[133] Additionally, the courts of Delaware have moved toward applying the same general fiduciary framework to controlling shareholders that they apply to corporate directors. However, an activist shareholder is not necessarily a controlling shareholder. Thus, many activist shareholders are not subject to fiduciary duties under Delaware law. In contrast, under British law, other parties besides *de jure* directors and "controlling shareholders" are subject to fiduciary duties.

Kahn, 638 A.2d at 1115; *Sinclair Oil*, 280 A.2d at 720; Sterling, 93 A.2d at 109-110.

127. *Sinclair Oil*, 280 A.2d at 720 (referring to fiduciary duties of loyalty in parent/subsidiary relations); *accord Kahn*, 638 A.2d at 1115. *See also In re* Primedia Inc. Derivative Litig., 910 A.2d 248, 257 (Del. Ch. 2007) (stating that *Sinclair* applies to controlling shareholders).

128. *Nixon*, 626 A.2d at 1375-76.

129. *Kahn*, 638 A.2d at 1115 (citing *Weinberger*, 457 A.2d at 710).

130. *Id*.

131. *Weinberger*, 457 A.2d at 703. The controlling shareholder "retains the burden of showing complete disclosure of all material facts relevant to [the] vote." Rosenblatt v. Getty, 493 A.2d 929, 937 (Del. 1985).

132. *E.g.*, *Kahn*, 638 A.2d at 1115 (Del. 1994) (cash-out merger).

133. *Kahn*, 638 A.2d at 1113-14; *Gradient OC Master*, 930 A.2d at 130.

III. THE COMPANIES ACT OF THE UNITED KINGDOM

The Companies Act of 2006 regulates the Public Limited Company (PLC) business organization.[134] A PLC is the British equivalent of a Delaware corporation. Like a Delaware corporation, a PLC enjoys a separate legal existence,[135] limited liability,[136] centralized management,[137] and transferable ownership interests.[138] In addition, the Companies Act of 2006 imposes general duties upon the directors of PLCs.[139] More importantly, the Companies Act of 2006 imposes general duties upon *shadow directors.*[140] These are individuals who have significant influence, but who "lurk[] in the shadows," sheltering themselves behind those who claim to be the real directors.[141]

A. Activist Shareholders as Shadow Directors

The Companies Act of 2006 extends the obligations of company directors to parties that exercise the influence of directors, *i.e.*, to shadow directors.[142] However, shadow directors are not actual directors and have no legal authority to act on the company's behalf.[143] Instead, a shadow director is usually a significant shareholder or creditor of the company.[144]

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134. Companies Act, 2006, c. 46 (U.K.).

135. Salomon v. Salomon & Co., [1897] A.C. 22 (H.L.) (appeal taken from Eng.) (U.K.); *see also* FRANK ERNEST PERRY & JOHN E. KELLY, LAW AND PRACTICE RELATING TO BANKING 113 (5th ed. 1987) ("A limited company has a legal existence of its own, quite apart from that of the shareholders or members of which it is composed").

136. *See* Companies Act, 2006, c. 46, § 3 (U.K.) ("A company is a 'limited company' if the liability of its members is limited by its constitution.").

137. Under British law, the articles of association of a PLC allocate the powers of management among the organs of the PLC, including the board of directors and the membership. ANDREW HICKS & S.H. GOO, CASES AND MATERIALS ON COMPANY LAW 222 (6th ed. 2008). However, § 20(1) of the Companies Act of 2006 provides:

> On the formation of a limited company . . . if articles are not registered, or . . . if articles are registered, in so far as they do not exclude or modify the relevant model articles, the relevant model articles (so far as applicable) form part of the company's articles in the same manner and to the same extent as if articles in the form of those articles had been duly registered.

Companies Act, 2006, c. 46, § 20(1) (U.K.). Schedule 3 of the Companies Regulations of 2008 includes the current model articles. Section 3 of those model articles provide: "[T]he directors are responsible for the management of the company's business, for which purpose they made exercise all the powers of the company." The Companies (Model Articles) Regulations, 2008, S.I. 2008/3229, sched. 3, § 3 (U.K.). Thus, the default rule for PLCs is centralized management.

138. Houston Putnam Lowry & Peter W. Schroth, *Survey of 1993 Developments in International Law in Connecticut*, 68 CONN. B.J. 222, 223 (1994) ("In England, the company whose shares can be traded readily is now a public limited company").

139. Companies Act, 2006, c. 46, §§ 170-177 (U.K.).

140. *See Id.* § 170(5) ("The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply").

141. *In re* Hydrodan (Corby) Ltd., [1994] BCC 161, 163.

142. Simon Plant & Michel Prior, *Officers' and Directors' Liability in the Context of Insolvency*, 28 INT'L BUS. LAW. 303, 304 (2000).

143. *Id.* at 304.

144. Caroline Bradley, *Transatlantic Misunderstandings: Corporate Law and Societies*, 53

According to section 251(1) of the Companies Act of 2006, a shadow director is "a person in accordance with whose directions or instructions the directors of the company are accustomed to act."[145] The question of whether a party is a shadow director is a question of fact – the answer "must be objectively ascertained by the court in the light of all the evidence."[146] Thus, like Delaware's controlling-shareholder analysis, the shadow director analysis defies distillation into a heuristic. However, in *Secretary of State for Trade and Industry v. Deverell*,[147] the Court of Appeal of England and Wales provided invaluable insight into the shadow director analysis.[148]

In *Deverell*, the court interpreted section 22(5) of the Company Directors Disqualification Act of 1986 (the "Disqualification Act").[149] The text of section 22(5) is identical to the text of section 251(1) of the Companies Act of 2006.[150] Because this text mirrors that of Section 251(1) of the Companies Act of 2006, the Court of Appeal's interpretation of Section 22(5) in *Deverell* is relevant in interpreting Section 251(1).

According to *Deverell*, a party is a shadow director if the party exerts a "real influence in the corporate affairs of the company."[151] However, a party need not exercise that influence "over the whole field of [the company's] corporate activities" to be a shadow director.[152] Furthermore, even though a company's board of directors "will normally adhere to the guidance tendered by a shadow director, it is not essential that [such guidance] is habitually followed or that there is any expectation that it will be followed."[153] Thus, a shadow director is a party that customarily offers advice, instructions, or directions to the company's board of directors which carries "real influence" as to at least a part of the business and affairs of the company.[154]

Next, a shareholder may be a shadow director even if the board of directors

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U. MIAMI L. REV. 269, 294 (1999).

145. Companies Act, 2006, c. 46, § 251(1) (U.K.).

146. Secretary of State for Trade and Industry v. Deverell, [2001] Ch. 340 (C.A.) (interpreting an analogous provision of the Company Directors Disqualification Act of 1986).

147. *Id.*

148. The Court of Appeal of England and Wales is the second-highest court in English legal system. Currently, the Supreme Court of the United Kingdom hears appeals from the Court of Appeal. Previously, the House of Lords heard appeals from the Court of Appeal. *See* Monica A. Fennell, *Emergent Identity: A Comparative Analysis of the New Supreme Court of the United Kingdom and the Supreme Court of the United States*, 22 TEMPLE INT'L & COMP. L. J. 279 (2008).

149. [2001] *Deverell* Ch. 340 (C.A.).

150. *Compare* Company Directors Disqualification Act, 1986, c. 46, § 22(5) (U.K.) *with* Companies Act, 2006, c. 46, § 251(1) (U.K.).

151. [2001] *Deverell* Ch. 340 (C.A.).

152. *Id.*

153. Stephen Griffin, *Problems in the Identification of a Company Director*, 54 N. IR. LEGAL Q. 43, 52 (2003).

154. *Id.* (interpreting *Deverell*).

does not adopt a subservient role or surrender its discretion to the shareholder.[155] That is, a shareholder may be a shadow director *even if* the board of directors has the capacity to exercise independent judgment. In contrast, under Delaware law, a shareholder is only a controlling shareholder if the shareholder can substitute its judgment for the judgment of the board of directors,[156] or dictate the composition of the board of directors.[157] As demonstrated, such dominion over the board of directors is not a necessary condition of being a shadow director. Therefore, the definition of "shadow director" under the Companies Act of 2006 is broader than the definition of "controlling shareholder" under Delaware law.

Altogether, the shadow director analysis imposes the obligations of directors upon parties that exercise the authority or influence of individual directors. In contrast, the controlling-shareholder calculus imposes the responsibilities of directors upon shareholders that exercise the authority of the entire boards of directors. This is the defining difference between Delaware's controlling-shareholder analysis and the United Kingdom's shadow director analysis. In addition, the logic of the United Kingdom's shadow director analysis is robust and alluring – a party that exercises the authority of a company director should have responsibility commensurate with that authority.

Activist shareholders that would escape classification as controlling shareholders under Delaware law may not evade categorization as shadow directors. Furthermore, as foreshadowed in the preceding paragraph, activist shareholders categorized as shadow directors are subject to the duties of directors.[158]

B. The General Duties of Directors of Public Limited Companies[159]

Since 1742, the British common law has defined directors of companies as trustees and imposed fiduciary duties upon them.[160] Today, the Companies Act of

155. [2001] *Deverell* Ch. 340 (C.A.).

156. *See Kahn*,638 A.2d at 1114-15.

157. *See In re Cysive*, 836 A.2d at 552.

158. Ultraframe (UK) Ltd. v. Fielding, [2005] All E.R. (D) 397 (Ch.) (interpreting the Companies Act of 1985) (imposing all the statutory duties of the Companies Act of 1985 onto shadow directors, but not imposing all of the fiduciary duties of a director onto shadow directors); *see also* Companies Act, 2006, c. 46, § 170(5) (U.K.) ("The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply").

159. There is no statutory Business Judgment Rule in the United Kingdom. However, there is a common law business judgment rule, as British courts do not "substitute [their] opinion for that of the management, or . . . question the correctness of the management's decision . . . if bona fide arrived at." Howard Smith Ltd v. Ampol Petroleum Ltd [1974 A.C. 821, 832 (P.C.); U.K. Law Comm'n, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, Law Comm'n Rep. No. 261, ¶ 5.21 (1999).

160. L.S. Sealy, *The Director as Trustee*, 25 CAMBRIDGE L.J. 83, 83 (1967); *see also* Charitable Corp. v. Sutton, (1742) 26 Eng. Rep. 642, 644 (Ch.) ("[C]ommittee-men are most properly agents to those who employ them in this trust, and who empower them to director and superintend the affairs of the corporation").

2006 includes a codification of the common law duties of directors.[161] The codification "is in part a restatement of the common law and in part a reform of it."[162] Thus, the general duties imposed by the Companies Act of 2006 may differ from the fiduciary duties imposed by the common law.[163] The codification includes seven general duties:

(1) The duty "to act within [the director's] powers";[164]
(2) The duty "to promote the success of the company";[165]
(3) The duty "to exercise independent judgment";[166]
(4) The duty "to exercise reasonable care, skill and diligence";[167]
(5) The duty "to avoid conflicts of interest";[168]
(6) The duty "not to accept benefits from third parties";[169] and
(7) The duty "to declare interest in proposed transaction[s] or arrangement[s]."[170]

1. The Duty to Act within the Director's Powers

Section 171(a) of the Companies Act of 2006 requires a director of a company to "act in accordance with the company's constitution."[171] A company's constitution includes its articles of association and any resolution passed or decision taken in accordance with its articles of association.[172] In all, section 171(a) establishes that a director has a duty not to take *ultra vires* action.[173]

Under section 171(b), a director of a company must "only exercise powers for

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161. *See* Companies Act, 2006, c. 46, §§ 170-177 (U.K.).

162. Paul Davies & Jonathan Rickford, *An Introduction to the New UK Companies Act*, 5 EUR. CO. & FIN. L. REV. 48, 62 (2008). Section 170(3) states that the statutory duties have effect *in place of* the common law duties. Companies Act, 2006, c. 46, § 170(3) (U.K.) (emphasis added). However, Section 170(4) states that the statutory duties must be interpreted and applied as their corresponding common law duties were interpreted and applied. *Id.* § 170(4).

163. Section 170(3) states that the statutory duties have effect *in place of* the common law duties. Companies Act, 2006, c. 46, § 170(3) (U.K.). However, Section 170(4) states that the statutory duties must be interpreted and applied as their corresponding common law duties were interpreted and applied. *Id.* § 170(4).

164. Companies Act, 2006, c. 46, § 171 (U.K.).

165. *Id.* § 172.

166. *Id.* § 173.

167. *Id.* § 174.

168. *Id.* § 175.

169. *Id.* § 176.

170. Companies Act, 2006, c. 46, §§ 171, 177 (U.K.).

171. *Id.* § 171(a).

172. *Id.* §§ 17, 257; COMPANIES ACT 2006 50, ¶ 234 (Verlag Goyang Media Ltd. ed., BoD GmbH 2008); *see also* CORPORATE BUSINESS FORMS IN EUROPE: A COMPENDIUM OF PUBLIC AND PRIVATE LIMITED COMPANIES IN EUROPE 85, ¶ 193 (Frank Dornseifer ed., Sellier European Law Publishers 2005) ("A director must not act in a way that exceeds the powers conferred on him by . . . Articles of Association of the company.").

173. The term "*ultra vires*" means "[u]nauthorized" or "beyond the scope of power allowed or granted by a corporate charter or by law." BLACK'S LAW DICTIONARY 1662 (9th ed. 2009).

the purposes for which they are conferred."[174] Section 171(b) codifies the common law proper purposes rule.[175] The courts of the United Kingdom have notably applied the common law proper purpose rule in *Re Smith and Fawcett Ltd.*,[176] *Hogg v. Cramphorn, Ltd*,[177] and *Howard Smith Ltd. v. Ampol Petroleum Ltd*.[178] In determining the "purpose for which [the powers] are conferred,"[179] British courts "consider[] the relevant article in the light of the general theme of the articles [of association] as a whole."[180] If a court determines that a director exercised his authority for an improper purpose, the exercise of authority is voidable, and the director is liable for damages.[181]

Section 171(b) and the common law proper purpose rule is similar to the rule pronounced in *Schnell v. Chris-Craft Industries., Inc*.[182] In *Schnell*, the Delaware Supreme Court held "that inequitable action does not become permissible simply because it is legally possible."[183] While the proper purpose rule and the *Schnell* rule are not identical, both rules act to constrain exercises of board authority to proper or equitable purposes. Thus, the proper purpose rule is a British version of the *Schnell* rule and is best understood in that context.

2. The Duty to Promote the Success of the Company

Section 172(1) of the Companies Act of 2006 requires a director of a PLC to "act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole."[184] In addition, the Act provides a non-exhaustive list of factors a director must consider:

(a) the likely consequences of any decision in the long term,

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174. Companies Act, 2006, c. 46, § 171(b) (U.K.).

175. DEP'T OF TRADE AND INDUSTRY, COMPANIES ACT 2006: EXPLANATORY NOTES 50, ¶ 323 (2006), *available at* http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpgaen_20060046_en.pdf [hereinafter "Explanatory Notes] ("This duty codifies the current principle of law under which a director should exercise his powers . . . for a proper purpose"); Robert Goddard, *Directors' Duties*, 12 EDINBURGH L. REV. 468, 470 (2008).

176. [1942] Ch. 304 (H.C.).

177. [1967] Ch. 254 (H.C.).

178. [1974] A.C. 821 (P.C.).

179. Companies Act, 2006, c. 46, § 171(b) (U.K.).

180. Fraser Dobbie, *Codification of Directors' Duties: An Act to Follow?*, 11 TRINITY C. L. REV. 13, 20 (2008).

181. GEOFFREY MORSE ET AL., PALMER'S COMPANY LAW: ANNOTATED GUIDE TO THE COMPANIES ACT 2006 165 (2007) (citing Howard Smith Ltd. v. Ampol Petroleum Ltd., [1974] A.C. 821 (P.C.)).

182. 285 A.2d 437 (Del. 1971).

183. *Id*. at 439.

184. Companies Act, 2006, c. 46, § 172(1) (U.K.). This statutory duty corresponds to a common law duty: Directors "must exercise their discretion *bona fide* in what they consider – not what a court may consider – is in the interests of the company." Re Smith and Fawcett Ltd., [1942] Ch. 304, 306 (H.C.) (emphasis added); *see also* Dorchester Fin. Co. v. Stebbing, [1989] B.C.L.C. 498, 501-502 (H.C.) ("A director must exercise any power vested in him as such, honestly, in good faith and in the interests of the company").

(b) the interests of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company.[185]

Thus, the Companies Act of 2006 "imposes a legally enforceable obligation on the board [of directors] to consider non-shareholder interests in the decision making process."[186] This is referred to as the "enlightened shareholder value" approach.[187]

Under this approach, the directors of a company must "primarily . . . focus on the promotion of the best interests of [shareholders], but . . . must [also] consider the interests of major stakeholders where appropriate."[188] That is, the directors should consider the interests of non-shareholder constituencies where such consideration "promotes the success of the company for the benefit of its [shareholders]."[189] Thus, the approach is merely a reminder that "pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones."[190]

Under Delaware law, the fiduciary duty of loyalty requires corporate directors "to act in the best interests of the corporation and its shareholders . . . ."[191] Thus, corporate directors must subordinate the interests of other corporate constituencies, including employees and the community, to the interests of the corporation and its shareholders. However, corporate directors should consider the interests of other corporate constituencies to the extent those interests intersect with the best interests of the shareholders. Therefore, this concept is similar to the "enlightened shareholder value" approach. The duty to promote the success of the company is a British version of this core demand of Delaware's fiduciary duty of loyalty.

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185. Companies Act, 2006, c. 46, § 172(1)(a)-(f) (U.K.).

186. Timothy P. Glynn, *Communities and Their Corporations: Towards a Stakeholder Conception of the Production of Corporate Law*, 58 CASE W. RES. L. REV. 1067, 1094 (2008).

187. Explanatory Notes, supra note 175, at 50, ¶ 325; Daniel Attenborough, *The Company Law Reform Bill: An Analysis of Directors' Duties and the Objective of the Company*, 27 COMPANY LAW 162, 165 (2006).

188. Dobbie, *supra* note 180, at 18; *see also* John Lowry, *The Duty of Loyalty of Company Directors: Bridging the Accountability Gap Through Efficient Disclosure*, 68 CAMBRIDGE L.J. 607, 616 (2009) ("Under [the 'enlightened shareholder value'] approach, directors, whilst ultimately required to promote shareholder interests, must take account of the factors affecting the company's relationships and performance.").

189. Lowry, *supra* note 188, at 616.

190. DEP'T OF TRADE AND INDUS., COMPANIES ACT 2006: DUTIES OF COMPANY DIRECTORS: MINISTERIAL STATEMENTS 2 (2007), *available at* http://www.bis.gov.uk/files/file40139.pdf.

191. ATR-Kim Eng Fin. Corp. v. Araneta, No. 489-N, 2006 WL 3783520, at 56 (Del Ch. Dec. 21, 2006) (citing *Guth*, 5 A.2d at 510.).

3. The Duty to Exercise Independent Judgment

Section 173(1) of the Companies Act of 2006 provides that "[a] director of a company must exercise independent judgment."[192] Unfortunately, the term "independent judgment" is not defined in the Act.[193] However, the usage of the word "independent" suggests that a director's opinion must not be "fettered or limited, restricted in any way."[194] That is, "a director should be in a position to make up his own mind on the issue in question and not be influenced or prejudiced by any matter."[195]

It has been suggested that the rule of section 173(1) "is necessary to ensure that the board [of directors] is not acting in the interests of [another party] . . . ."[196] However, if the rule "applied without limitation it would make companies very unreliable contracting partners,"[197] because contracts bind parties and limit future discretion. Therefore, it is "necessary to limit this rule significantly to enable the board to fetter their discretion where [it] believe[s], at the time of the contract, it is in the best interests of the company."[198] Consequently, the Companies Act of 2006 limited section 173(1)'s duty to exercise independent judgment by establishing two exceptions to it under section 173(2).[199]

First, a director cannot violate this duty by acting "in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors."[200] Such an agreement need not be in writing.[201] Second, a director cannot violate this duty by acting "in a way authorised by the company's constitution."[202] Thus, section 173(2) limits the reach of section 173(1) in order to both maintain "the contractual reliability of companies" and protect "economic efficiency."[203]

Under Delaware law, the fiduciary duty of loyalty requires corporate directors to exercise independent judgment.[204] "Independence" means that "a director's

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192. Companies Act, 2006, c. 46, § 173(1) (U.K.). This statutory duty corresponds to a common law duty: "[D]irectors must exercise their powers independently, without subordinating their powers to the will of others, whether by delegation or otherwise (unless authorised by or under the constitution to do so)." Explanatory Notes, supra note 175 at 51, ¶ 333; SALEEM SHEIKH, A GUIDE TO THE COMPANIES ACT 2006 417 (2008).

193. SHEIKH, *supra* note 192, at 417.

194. *Id.*

195. *Id.*

196. Dobbie, *supra* note 180, at 20; PAUL L. DAVIES, INTRODUCTION TO COMPANY LAW 68-69 (2002).

197. Dobbie, *supra* note 180, at 20 (2008); DAVIES, *supra* note 196, at 199.

198. Dobbie, *supra* note 180, at 20 (2008); Fulham Football Club v. Cabra Estates PLC, [1994] B.C.L.C. 363 (Ch.).

199. *See* Companies Act, 2006, c. 46, § 173(2)(a) (U.K.).

200. *Id.*

201. SHEIKH, *supra* note 192, at 417.

202. Companies Act, 2006, c. 46, § 173(2)(b) (U.K.).

203. Dobbie, *supra* note 180, at 20-21.

204. *Cede & Co.*, 634 A.2d at 362; Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate*

decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[205] Therefore, corporate directors exercise independent judgment where their judgment is free from extraneous considerations or influences – that is, where it is unfettered or unrestricted. This is similar to the requirements of the British duty to exercise independent judgment. Furthermore, the duty to exercise independent judgment is probably an application of the duty to promote the success of the company,[206] a British duty of loyalty. In all, the duty to exercise independent judgment is a British version of yet another demand of Delaware's fiduciary duty of loyalty.

4. The Duty to Exercise Reasonable Care, Skill and Diligence

Section 174(1) of the Companies Act of 2006 provides that "[a] director of a company must exercise reasonable care, skill and diligence."[207] Moreover, section 174(2) provides the applicable standard of care:

> This means the care, skill and diligence that would be exercised by a reasonably diligent person with—(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has.[208]

The standard of care includes both an objective and a subjective component.[209] Thus, a director cannot escape liability because of his subjective lack of knowledge, skill, and experience.[210] Moreover, a director with higher levels of knowledge, skill, and experience will be expected to perform to that heightened standard.[211] Case law has revealed two specific applications of this duty.

First, a director has the duty to be informed of the business and affairs of the PLC and should have sufficient knowledge to accomplish that task.[212] Thus, the

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Scandals, 60 FLA. L. REV. 589, 615 (2008); *see also* Telxon v. Meyerson, 802 A.2d 257, 264 (Del. 2002) ("Directors must not only be independent, but must act independently"); Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002) ("As a general matter, the business judgment rule presumption that a board acted loyally can be rebutted by alleging facts which, if accepted as true, establish that the *board* . . . lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders").

205. *Aronson v. Lewis*, 473 A.2d at 816.

206. *See* Dobbie, *supra* note 180 at 21 ("It has been observed that this duty . . . is probably just an application of [the duty to promote the success of the company]").

207. Companies Act, 2006, c. 46, § 174(1) (U.K.).

208. *Id.* § 174(2).

209. Re D'Jan of London Ltd, (1994) 1 B.C.L.C. 561 (interpreting an analogous provision (section 214) of the Insolvency Act of 1986). Section 174(1) of the Companies Act of 2006 was modeled on Section 214 of the Insolvency Act of 1986. SHEIKH, *supra* note 1942, at 418 (citing Re Produce Mktg. Ltd. [1989] B.C.L.C. 513 (Ch.) and Re MC Bacon, Ltd., [1990] B.C.L.C. 324 (Ch.)).

210. Re D'Jan of London Ltd, (1994) 1 B.C.L.C. 561.

211. *Id.*

212. Re Barings PLC, (1999) 1 B.C.L.C. 433 (Ch.) (interpreting an analogous provision (Section 6) of the Company Directors Disqualification Act of 1986).

law does not tolerate the existence of "dummy directors,"[213] or directors who lack business knowledge. Under Delaware law, the fiduciary duty of care requires corporate directors to "inform[] themselves 'prior to making a business decision, of all material information reasonably available to them.'"[214] However, the standard of review under the British duty is more exacting (ordinary negligence).[215] This application of the duty to exercise reasonable care, skill, and diligence is a British version of the application of Delaware's duty of care established in *Smith v. Van Gorkom*.

Second, a director has a duty to monitor the business and affairs of the PLC.[216] This duty exists because a director remains responsible for his functions even if the director delegates those functions to another person or entity.[217] In *Re Barings PLC (No. 5)*, after Nicholas Leeson committed fraud while marching Barings Bank, England's oldest investment bank, straight into insolvency, the High Court disqualified three directors for breaching their duty of care by failing to have an adequate system for monitoring legal compliance.[218] Under Delaware law, the fiduciary duties of good faith and loyalty require corporate directors to exercise oversight, in good faith, over the business and affairs of the corporation.[219] However, because this duty of oversight lies in the duties of good faith and loyalty, more than gross negligence is required to establish a breach.[220] In all, the British application of the duty to exercise reasonable care, skill, and diligence is a less-forgiving version of Delaware's duty of oversight, as set forth in *Caremark*, *Guttman*, and *Stone*. As a result, this duty is similar to, but more exacting than, Delaware's duty of care.

5. The Duty to Avoid Conflicts of Interest

Section 175(1) of the Companies Act of 2006 provides that "[a] director of a company must avoid a situation in which he has, or can have, a direct or indirect

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213. The term "dummy director" refers to "[a] board member who is a mere figurehead and exercises no real control over the corporation's business." BLACK'S LAW DICTIONARY 527 (9th ed. 2009). In THE NINE OLD MEN, authors Drew Pearson and Robert S. Allen affectionately dubbed Justice Willis Van Devanter "The Dummy Director." Laura K. Ray, *Inside the Marble Palace*, 12 GREEN BAG 2D 321, 324 (2009) (book review). Of course, every school-age child and law student knows that the Four Horsemen are "dummy directors" taking cues from Satan, a narrow reading of the Commerce Clause, and Liberty of Contract.

214. *Smith*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812); *accord* In re *Transkaryotic Therapies, Inc.*, 954 A.2d at 368.

215. *See Re Barings PLC*, 1 B.C.L.C. 433.

216. *Re Barings PLC*, 1 B.C.L.C. 433 (interpreting an analogous provision (Section 6) of the Company Directors Disqualification Act of 1986).

217. *Id.*

218. *Id.*

219. *Stone*, 911 A.2d at 370; *Guttman*, 823 A.2d at 505-506; In re *Caremark Int'l Inc. Derivative Litig.*, 698 A.2d at 971.

220. *See Stone*, 911 A.2d at 369-70 (requiring a breach of the fiduciary duties of good faith and loyalty to establish a *Caremark* claim); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 64, 66 (Del. 2006) ("[T]o afford guidance we address the issue of whether gross negligence . . . , without more, can also constitute bad faith. The answer is clearly no").

interest that conflicts, or possibly may conflict, with the interests of the company."[221] This duty replaced the common law no-conflict rule.[222] Under the no-conflicts rule, "a director must not put himself in a position in which his personal interests conflict, or may possibly conflict, with the company's interest."[223] Traditionally, the no-conflicts rule was *strictly applied*. That is, a director could not raise issues of fairness, "such [as] the company's incapacity to exploit an opportunity," to relieve directors of their liability.[224] Compared to the no-conflict rule, the new statutory duty provided by section1751(1) injects needed flexibility into British corporate opportunity law.

While the general rule in section 175(1) appears to provide an uncompromising rule, accompanying provisions soften its stern demeanor. First, section 175(3) precludes the duty from applying "to a conflict of interest arising in relation to a transaction or arrangement with the company."[225] Thus, the duty to avoid conflicts of interests does not foreclose the possibility that directors may enter into transactions with the company. Second, under section 175(4), the duty is not violated "if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest"[226] or "if the matter has been authorized by the directors."[227] The former exception eliminates liability for unexpected conflicts of interests, while the latter exception allows the authorization of conflicts by the directors.

Traditionally, the British courts have divided conflicts of interest into three categories: (1) conflicts arising from transactions with the company, (2) conflicts arising from assuming company opportunities, and (3) conflicts arising from competition with the company. As previously mentioned, there is no affirmative duty to avoid conflicts "arising in relation to a transaction or arrangement with the company." [228] Consequently, section 175 only regulates the conflicts described in (2) and (3).

Under section 175, a company director must avoid conflicts of interest arising from assuming company opportunities. Thus, a company director cannot assume

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221. Companies Act, 2006, c. 46, § 175(1) (U.K.).

222. Department of Trade and Industry (U.K.), Companies Act 2006: Explanatory Notes 50, ¶ 338 (2006).

223. Kershaw, *Lost in Translation: Corporate Opportunities in Comparative Perspective*, 25 OXFORD J. LEGAL STUD. 603, 605 (2005) (citing Aberdeen Railway Co. v. Blaikie Brothers, [1843-1860] All E.R. 249 (H.L.)).

224. Kershaw, *supra* note 223, at 620-21; *see also* Boardman v. Phipps, (1967) 2 A.C. 46 (H.L.); Regal (Hastings) Ltd. v. Gulliver, (1967) 2 A.C. 134 (H.L.). The courts of Delaware apply the corporate opportunities doctrine instead of the no-conflict rule. Kershaw, *supra* note 223, at 608.

225. Companies Act, 2006, c. 46, § 175(3) (U.K.). Section 177 handles conflicts of interest arising in relation to a transaction or arrangement with the company by requiring disclosure of director interests. *See id.* § 177.

226. *Id.*§ 175(4)(a).

227. *Id.* § 175(4)(b). The directors may authorize conflicts of interest pursuant to Section 176(5)-(6). *See id*. § 175(5)-(6).

228. *Id.* § 175(3).

company opportunities unless the board of directors authorizes the assumption of the opportunity.[229] In contrast, a director or controlling shareholder of a Delaware corporation may assume corporate opportunities under Delaware's Corporate-Opportunity Doctrine, an application of Delaware's fiduciary duty of loyalty.[230]

Under the Corporate-Opportunity Doctrine, a corporate director *may* take a corporate opportunity if:

> (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity, (2) the opportunity is not essential to the corporation, (3) the corporation holds no interest or expectancy in the opportunity, and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity."[231]

This analysis is fact-specific and no single factor is dispositive.[232] Despite this test, Delaware courts merely balance the equities of the director's action.[233] Thus, in a sense, the primary difference between the British approach and the Corporate-Opportunities Doctrine is the issue of "fairness."

Next, under section 175, a company director must avoid conflicts of interest arising from competition with the company. Therefore, a company director cannot compete against the company unless the board of directors authorizes the assumption of the opportunity.[234] In contrast, a director or controlling shareholder of a Delaware corporation may compete against the corporation.[235]

Under Delaware law, a corporate fiduciary may engage "in an independent competitive business, so long as he violates no legal or moral duty with respect to the fiduciary relation that exists between the corporation and himself."[236] Therefore, the only limitations upon a corporate fiduciary competing against the corporation are the fiduciary duties of loyalty and good faith.[237] Altogether, the place of fairness in the fiduciary calculus again distinguishes the Delaware rule from the British rule.

Delaware courts have not announced a duty, obligation, or demand for corporate directors to avoid conflicts of interest. Instead, Delaware relies on fairness to review conflicts of interests and loyalty to the corporation and its shareholders. This approach is more forgiving than the British approach, which is

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229. *Id.*§ 175(4)(b).

230. Under the Corporate-Opportunity Doctrine, a corporate director "may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation." *Broz*, 673 A.2d at 154-55.

231. *Id.* (citing *Guth*, 5 A.2d at 509) (emphasis in original).

232. *Id.* at 155.

233. *Id.*

234. Companies Act, 2006, c. 46, § 175(4)(b) (U.K.).

235. Craig v. Graphic Arts Studio, Inc., 166 A.2d 444, 449 (Del. Ch. 1960).

236. *Id.*

237. The fiduciary duty of care is unlikely to be implicated.

an affirmative duty to avoid conflicts of interests. However, the duty to avoid conflicts has replaced the inveterate (and even less-forgiving) no-conflicts rule. In the future, the British rule will likely continue to converge towards the American version.

6. The Duty Not to Accept Benefits from Third Parties

Section 176(1) of the Companies Act of 2006 states that "[a] director of a company must not accept a benefit from a third party conferred by reason of . . . his being a director, or . . . his doing (or not doing) anything as director."[238] Section 176(1) "codifies the [common law] rule prohibiting the exploitation of the position of director for personal benefit."[239] Altogether, the duty not to accept benefits from third parties "prohibits the acceptance of benefits (including bribes)."[240]

However, the Companies Act of 2006 provides two exceptions. First, the duty is not breached "if the acceptance of [a] benefit cannot reasonably be regarded as likely to give rise to a conflict of interest."[241] Second, section 180(4) preserves "[a]ny current ability of the [shareholders] of a company to authorise the acceptance of benefits."[242] Thus, because there are at least two safe harbors, section 176 is not a categorical prohibition.

Presumably, a third party conveys a benefit to a director for one purpose – to curry favor with, and alter the conduct of, the director. That is, the third party attempts to diminish the disinterest or independence of the director by conveying a benefit. Under Delaware law, a corporate director that lacks either disinterest or independence is not entitled to the protections of the business judgment rule.[243] Essentially, where a corporate director is interested or lacks independence, the director violates her fiduciary duty of loyalty. Thus, the fiduciary duty of loyalty prohibits conduct similar to the conduct prohibited by section 176. This section aims to preserve the disinterest and independence of director and is similar to the aforementioned application of Delaware's fiduciary of loyalty.

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238. Companies Act, 2006, c. 46, § 176(1) (U.K.). "A 'third party' means a person other than the company, an associated body corporate or a person acting on behalf of the company or an associate body corporate." *Id.* § 176(2). In addition, "[b]enefits received by a director from a person by whom his services (as a director or otherwise) are provided to the company are not regarded as conferred by a third party." *Id.* § 176(3).

239. Explanatory Notes, supra note 175, at 50, ¶ 344; SHEIKH, *supra* note 195, at 421; *see also* A-G for Hong Kong v. Reid, (1994) 1 A.C. 324 (P.C.) (appeal from New Zealand) (stating and applying the common law rule).

240. Explanatory Notes, supra note 175, at 50, ¶ 344.

241. Companies Act, 2006, c. 46, § 176(4) (U.K.); Explanatory Notes, supra note 175, at 50, ¶ 346.

242. Explanatory Notes, supra note 175, at 50, ¶ 345.; *see also* Companies Act, 2006, c. 46, § 180(4) (U.K.).

243. DREXLER ET AL., *supra* note 66 at § 15.05[1]-[1A].

7. The Duty to Declare Interest in Proposed Transactions or Arrangements

According to section 177(1) of the Companies Act of 2006, "[i]f a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, [the director] must declare the nature and extent of that interest to the other directors."[244] A director must only declare such interests of which he is aware or ought reasonably to be aware.[245] Because even an indirect interest must be declared, a "director does not need to be a party to the transaction for the duty to apply."[246] Thus, another person's interest in a transaction with the company may trigger the duty and mandate a disclosure.[247] However, a declaration is not necessary "if the [transaction] cannot reasonably be regarded as likely to give rise to a conflict of interest."[248]

Under Delaware's fiduciary duty of disclosure, corporate directors have "an 'unremitting obligation' to deal candidly with their fellow directors."[249] Under this duty of candor or disclosure, corporate directors must "disclose all material information relevant to corporation decisions from which they may derive a personal benefit."[250] Thus, under Delaware law, corporate directors must declare interests in proposed transactions and arrangements. The duty to declare interest in proposed transaction or arrangements is a British analogue of Delaware's fiduciary duty of disclosure.

IV. ANALYSIS

The similarity of the duties of directors under the Companies Act of 2006 and Delaware law reflects their common origin in British common law.[251] Henry II

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244. Companies Act, 2006, c. 46, § 177(1) (U.K.). "The equitable rule that directors may not have interests in transactions with the company unless the interest has been authorised by the members is replaced by this duty." Explanatory Notes, supra note 175, at 50, ¶ 347.

245. Companies Act, 2006, c. 46, § 177(5) (U.K.).

246. Explanatory Notes, supra note 175, at 50, ¶ 347.

247. *Id.*

248. Companies Act, 2006, c. 46, § 177(6)(a) (U.K.); Explanatory Notes, supra note 175, at 50, ¶ 353.

249. *HMG/Courtland Properties, Inc.*, 749 A.2d at 119.

250. *Mills Acquisition Co.*, 559 A.2d at 1280; *accord HMG/Courtland Properties, Inc.*, 749 A.2d at 119.

251. *See* L.C.B. Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1370 (1956) ("Both [the American and British corporation laws] are based on the same general principles of law and equity derived from a common heritage . . . ."); Philip Bovey, *A Damn Close Run Thing—The Companies Act 2006*, 29 STAT. L. REV. 11, 11, (2008) (The Companies Act of 2006 "codifies some but by no means all of the common law relating to companies, in particular the law relating to directors' duties."); William B. Chandler, *The Delaware Court of Chancery and Public Trust*, 6 U. ST. THOMAS L. J. 421, 423 (2009) ('Fiduciary duties are an ancient concept in our law, and one that the Delaware Court of Chancery inherited from the English common law more than 300 years ago"); Byron F. Egan, *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 TEX. J. BUS. L. 45, 51 (2009) (noting, with respect to Delaware law, "The concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of both trusts and agency from over two

established the foundation of the English common law in the latter half of the twelfth century.[252] Later, the Delaware Constitution of 1776 incorporated the English common law into the law of Delaware.[253] However, over time, Delaware law has diverged from its English common law roots.

A. Divergent Director Duties

Under Delaware law, the fiduciary duties of corporate directors derive from the quasi-trustee and agency relationship that the directors have with the corporation and its shareholders.[254] That is, the directors of a corporation are fiduciaries and agents of the corporation and its shareholders, but not trustees.[255] Reflecting this fact, the duties of loyalty and care owed by directors of Delaware corporations are more relaxed than the fiduciary duties owed by trustees.[256]

In comparison, the United Kingdom has statutorily enacted general duties that draw upon, but also replace, their common law ancestors. While the U.K.'s general duties are similar to Delaware's fiduciary duties, the two are not identical. The two most substantial differences are: (1) the standards of review for the two jurisdictions' duties of care; and (2) the place of "fairness" in reviewing the conduct of corporate/company fiduciaries. The primary focus of this article has been on the duty of loyalty, examining how it prevents activist shareholders from being disloyal to the corporation and its shareholders. Thus, while the difference in the standards of review for the duties of care is interesting, it lacks relevance. Hence, the succeeding analysis will focus on the second difference.

The question presented here is whether Delaware should adopt the British approach to the duty of loyalty and preclude activist shareholders from raising issues of fairness to defend themselves from liability for violations of the fiduciary duty of loyalty. This concept of fairness is broad and subsumes several doctrines applied by Delaware courts, including the entire fairness standard of review and the corporate-opportunities doctrine. Regardless of specific applications, the

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hundred years ago.").

252. David R. Cleveland, *Draining the Morass: Ending the Jurisprudentially Unsound Unpublication System*, 92 MARQ. L. REV. 685, 691 (2009); Joseph Biancalana, *For Want of Justice: Legal Reforms of Henry II*, 88 COLUM. L. REV. 433, 434 (1988); William Barbour, *Some Aspects of Fifteenth-Century Chancery*, 31 HARV. L. REV. 834, 834 (1918).

253. DEL. CONST. of 1776, art. XXV, *see also* Claudio v. Delaware, 585 A.2d 1278, 1291 (Del. 1991) (English common law became Delaware law upon independence).

254. Schoon v. Smith, 953 A.2d 196, 206 (Del. 2008); In re Shoe-Town, Inc. Stockholders Litig., 16 DEL. J. CORP. L. 404, 417 (Del. Ch. 1990); *see also* Gottlieb v. McKee, 107 A.2d 240, 243 (Del. 1954) ("While technically not trustees, [directors] stand in a fiduciary relation to the corporation and its stockholders"); Bodell v. Gen. Gas & Elec. Corp., 132 A. 442, 446 (Del. 1926) ("While [directors] are not trustees in the strict sense of the term, yet for convenience they have often been described as such").

255. *Schoon*, 953 A.2d at 206; *Guth*, 5 A.2d at 510.

256. Stegemeier v. Magness, 728 A.2d 557, 562 (Del. 1999); Oberly v. Kirby, 529 A.2d 445, 466-67 (Del. 1991); Cargill, Inc. v. JWH Special Circumstance LLC, 959 A.2d 1096, 1113 (Del. Ch. 2008); Eberhardt v. Christiana Window Glass Co., 81 A. 774, 778 (Del. Ch. 1911).

concept of fairness reduces to a simple analysis – balancing the equities of fiduciary action in light of the duty of loyalty. Here, Delaware should not abandon fairness in favor of a clear rule of law because fairness is efficient.

The decision to adopt a fairness standard of review embodies an important policy judgment: the benefits from allowing fair breaches of the duty of loyalty exceed both the potential for abusing fairness as a means of evading liability and the potential benefits from a simpler rule of law. That is, a fairness standard promotes economic efficiency. Without fairness, a corporate opportunity would lie fallow because the corporation lacks the resources to exploit that opportunity. Under the Companies Act of 2006, the opportunity will remain uncultivated because the corporate directors are subject to liability for seizing corporate opportunity.[257] In contrast, under Delaware law, a corporate director may be able to exploit the opportunity without liability.[258] In addition, the mechanics of fairness are similar to another doctrine that promotes economic efficiency – the theory of efficient breach of contract.

Robert Birmingham provided the first statement of the theory of efficient breach when he stated that "[r]epudiation of obligations should be encouraged where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered."[259] Similarly, under a fairness doctrine, a fiduciary may repudiate her duty of loyalty if the fiduciary places her principal in as good a position as her principal would have occupied, had the duty remained inviolate. The only substantive difference is the source of the breached duties (contract or law). However, efficient breaches of duties, whether created by operation of contract or law, should be encouraged. For this reason, Delaware should allow shareholders to justify illicit behavior by raising issues of fairness.

Regardless, the real strength of British company law as applied to activist shareholders is not its unremitting general duties. Instead, the true advantage of British company law in this context is its shadow director concept.

B. Activist Shareholders and the Authority of Directors

Under the shadow director concept, British courts may impose the general duties of directors upon any party that exerts a "real influence in the corporate affairs of the company."[260] Moreover, British courts may impose the general duties of directors upon a party even if the board of directors did not adopt a subservient

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257. *See* Companies Act, 2006, c. 46, § 175(2) (U.K.) ("[I]t is immaterial whether the company could take advantage of the . . . opportunity").

258. *See Broz*, 673 A.2d at 154-55 (explaining the Corporate-Opportunity Doctrine).

259. Robert Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970). Today, the most ardent supporter of the theory is the eminent jurist Richard A. Posner of the U.S. Court of Appeals for the 7th Circuit. *See* Lake River Corp. v. Carborundum Co., 769 F.2d 1284 (7th Cir. 1985) (Posner, J., discussing the theory of efficient breach).

260. Secretary of State for Trade and Industry v. Deverell, [2001] Ch. 340 (C.A.) (interpreting an analogous provision of the Company Directors Disqualification Act of 1986).

role or surrender its discretion to that party.[261] In contrast, Delaware courts will impose the fiduciary duties of directors upon a shareholder only if the shareholder can substitute its judgment for the judgment of the board of directors,[262] or can dictate the composition of the board of directors.[263] Therefore, Delaware law requires significantly greater control by a shareholder before it imposes fiduciary duties upon that shareholder. This is a key weakness in the struggle against rent-seeking activist shareholders.

The Delaware legislature and courts must ask an important question – whether the benefits of imposing fiduciary duties upon significant, yet non-controlling, shareholders exceed the costs of such a rule. A critical examination of the arguments against imposing this duty make it clear that the answer is yes.

The first argument against the imposition of fiduciary duties upon activist shareholders is that the fiduciary duties would impede positive activism. This argument is not persuasive. Like other corporate fiduciaries, including directors, officers, and controlling shareholders, activist shareholders would be entitled to the protections of the business judgment rule, common law safe-harbors, and other defenses. In practice, these defenses would protect activist shareholders from unscrupulous or inappropriate litigation.

For example, assume that an activist shareholder advocates a transaction and the corporation approves it. Soon thereafter, an opponent files a derivative action against the activist shareholder for damages.[264] Because of the business judgment rule, the action would not proceed beyond the pleading stage, unless the opponent pleads specific facts demonstrating a breach of fiduciary duty. That is, the opponent must plead sufficient facts showing a violation of the fiduciary duties of care or loyalty. In addition, Vice-Chancellor Strine has suggested that exculpation for breaches of the duty of care under section 102(b)(7) of the DGCL extends to shareholders.[265] Thus, in effect, only "interested" activist shareholders would need to be concerned. Even then, "interested" activist shareholders could still avail themselves of the common law safe-harbors.

The second argument against the imposition of fiduciary duties upon activist shareholders is unnecessary because other corporate fiduciaries, such as directors

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261. *Id.*

262. *See* Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1114-1115 (Del. 1994) (finding that "the non-Alcatel [independent] directors deferred to Alcatel because of its position as a significant stockholder and not because they decided in the exercise of their own business judgment that Alcatel's position was correct" supported the legal conclusion that Alcatel was a controlling shareholder subject to fiduciary duties).

263. *See In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 552 (Del. 2003) (finding that "[Carbonell's] voting power positions him well to elect a new slate [of directors] more to his liking without having to attract much, if any, support from public stockholders" supported the legal conclusion that Carbonell was a controlling shareholder subject to fiduciary duties).

264. This example assumes that there is no issue of demand futility, a concept explained in Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

265. *See* Abraham v. Emerson Radio Corp., 901 A.2d 751, 759 (Del. Ch. 2006) (discussing the limits of exculpation under § 102(b)(7) of the DGCL).

and officers, are already responsible for losses associated with rent-seeking by activist shareholders. This assertion is partially true. However, this argument is nothing more than a straw man that primarily serves to direct attention away from the moral culpability of rent-seeking shareholders.

The second argument is more persuasive because an activist shareholder cannot dominate the board of directors. That is, the board of directors can exercise independent judgment to approve or disapprove a rent-seeking transaction sponsored by a rent-seeking shareholder. A probable motive for exercising independent judgment to approve a rent-seeking transaction is managerial entrenchment. Managerial entrenchment occurs where managers, such as corporate directors, "make it costly for shareholders to replacement them."[266] When corporate directors take actions to entrench themselves, directors act disloyally and implicate their fiduciary duty of loyalty.[267] Therefore, it is true that, where corporate directors exercise their independent judgment to approve a rent-seeking transaction, they may be held liable for damages resulting from that transaction under a theory of managerial entrenchment.

However, the second argument amounts to nothing more than knocking over a straw man because liability under a theory of managerial entrenchment is notoriously difficult to establish.[268] Therefore, corporate directors are likely to escape liability for approving rent-seeking transactions. Moreover, corporate directors may unknowingly approve a rent-seeking transaction.

For example, assume that an activist shareholder, Willy Wonka, holds five percent of the common stock of Delicious Candy, Inc. (Delicious Candy). Delectable Candy, Inc. (Delectable Candy) approaches the board of directors of Delicious Candy with an offer to purchase Delicious Candy's Super-Secret Candy Division (the Division). Because of competitive concerns, Delicious Candy cannot disclose much information about the Division. Consequently, Delectable Candy rescinds the offer. In response, Wonka purchases five percent of the common stock of Delectable Candy and hedges away his economic interest in Delectable Candy. Then, Wonka pressures the board of directors of Delectable Candy into purchasing the Division. Acquiescing to Wonka, Delectable Candy's board purchases the Division. Soon thereafter, the federal government imposes sanctions upon the Division for using lead-based flavor enhancers in its candy. Thus, the purchase proves to be a costly blunder. As it turns out, Wonka was aware of the impending sanctions during the negotiations.

Here, the directors of Delectable Candy merely trusted that Willy Wonka requested the transaction in good faith. Consequently, the directors of Delectable Candy violated, at most, their fiduciary duty of care. That is, the directors failed to

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266. Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Management-Specific Investments*, 25 J. FIN. ECON. 123, 123 (1989).

267. *Portnoy*, 940 A.2d at 70; *see also Cede*, 634 A.2d at 363 (stating that actions taken for the purpose of entrenchment are disloyal).

268. Jeffrey P. Weiss, *The Effect of Director Liability Statutes on Corporate Law and Policy*, 14 J. CORP. L. 637, 653 (1989) (stating that a plaintiff must satisfy a "difficult burden of proof" to prove an entrenchment claim).

"inform[ ] themselves 'prior to making a business decision, of all material information reasonably available to them.'"[269] Unfortunately, corporate directors are rarely personally liable or otherwise financially responsible for breaches of their fiduciary duty of care.[270] Thus, the directors of Delectable Candy will probably escape personal liability for losses resulting from the purchase of the Division and Mr. Wonka's rent seeking. As a result, director liability is not a sufficient safeguard against rent-seeking shareholders.

Next, in the alternative, the pressure applied by Wonka may have been effective only because the directors wished to remain entrenched in their positions. That is, the directors were interested. In that case, the fiduciary duty of loyalty would be implicated and directorial liability may attach. Therefore, as suggested by the second argument, the directors of Delectable Candy may already be responsible for the losses associated with Wonka's rent-seeking. However, Delectable Candy could not recoup its losses from the deep pockets of Wonka, who is morally culpable for the damages as well. At most, Wonka may be deemed a dirty, rotten scoundrel. While director liability may attach under this scenario, it does not provides adequate compensation. Furthermore, it totally ignores the moral culpability of rent-seeking shareholders.

Delaware law currently ignores the moral culpability of interested rent-seeking shareholders. Of course, legal culpability is not always synonymous with moral culpability. However, as an aspirational matter, legal culpability should not diverge from moral culpability. Therefore, where legal culpability deviates from moral culpability, the deviation should be justified by some competing policy interest. Here, the competing policy interest is the interest in positive shareholder activism. That is, legal culpability diverges from moral culpability because imposing fiduciary duties upon activist shareholders discourages positive shareholder activism too much.

However, as previously shown, the business judgment rule provides adequate protection to corporate fiduciaries, meaning that positive shareholder action will not be significantly discouraged by imposing fiduciary duties upon activist shareholders. Only interested activist shareholders need fear that their positive activism can be mischaracterized as abusive or rent-seeking. Thus, the only real question is the value of shareholder activism by interested shareholders. The value of such activism is inherently low. In fact, this value is insufficient to justify the divergence between legal culpability and moral culpability. As a result, the law should apply the fiduciary duties of corporate directors requiring interested shareholders that exercise influence over a corporate transaction to show the fairness of the transaction to avoid liability for resulting losses.

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269. *Smith*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812); *accord* In re *Transkaryotic Therapies, Inc.*, 954 A.2d at 368.

270. In re *Walt Disney Co. Derivative Litig.*, 907 A.2d at 749, *aff'd*, 906 A.2d at 64, 66; Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L 393, 403 (2007).

V. CONCLUSION: IMPORTATION OF THE BRITISH APPROACH

In conclusion, the Delaware legislature or courts should impose the fiduciary duties of corporate directors upon activist shareholders that exert a real influence over the business and affairs of the corporation, *i.e.*, activist shareholders that exercise the authority or influence of corporate directors.