Article

Corporate Control and the Need for Meaningful Board Accountability

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'Control' cannot be prohibited by law; and perhaps it would be as well not to try. All that can be governed legally, is the result of controlling action.

—Adolf A. Berle, Jr. & Gardiner C. Means.[1]

INTRODUCTION

Only thirteen percent of Americans trust large corporations.[2] "Trust is a powerful motivator of economic behavior . . . . [A] lack of trust can have paralyzing effects on financing and investments."[3] A continued distrust of corporate

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1. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 238 (1932).

2. CHI. BOOTH/KELLOGG SCH., FINANCIAL TRUST INDEX, WAVE III RESULTS (2009), http://www.financialtrustindex.org.

3. *Economic Downturn Shakes Americans' Trust*, UNITED PRESS INT'L, Jan. 29, 2009, http://www.upi.com/Business_News/2009/01/29/Economic-downturn-shakes-Americans-trust/UPI-69511233288883/ (quoting comments of Pro-

America could have significant economic consequences for corporations and their stakeholders.

Yet, corporate law continues to defer to and protect the decisions of corporate boards and senior management.[4] This Article suggests that it is time to reassess corporate discretion, particularly in the context of stakeholder transactions that benefit certain shareholders or creditors at the expense of others. Corporate boards and senior management need flexibility to run a business, but their decision to reallocate the value of a corporation among stakeholders should be subject to increased scrutiny.[5]

Corporations are at the mercy of the individuals who run them. Those individuals are vulnerable to greed, self-interest, and outside influence, which may lead to decisions that impair corporate value. Courts traditionally have used fiduciary law to curb such abuse and govern "the result of controlling action."[6]

Although a variety of parties can influence corporate decisions,[7] courts generally impose fiduciary duties only on corporate directors, senior management, and certain shareholders.[8] Courts are reluctant to accord similar treatment to lenders, bondholders, suppliers, and other nonmanagement parties,[9] who also can exert significant influence over a corporation.[10]

fessor Paola Sapienza of the Kellogg School of Management at Northwestern University).

4. *See infra* Part V.B (using the business judgment rule as an example); *see also In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124–26 (Del. Ch. 2009) (invoking the business judgment rule in deciding to dismiss the plaintiffs' claims for failure to monitor and breach of duty of care but allowing their claim of waste against Citigroup's board for decisions allegedly contributing to Citigroup's massive losses in 2007–08); *In re* Bear Stearns Litig., 870 N.Y.S.2d 709, 718 (App. Div. 2008) (asserting that the board's approval of merger was protected by the business judgment rule).

5. *See infra* Part V.C (introducing a proposal to accomplish this goal).

6. BERLE & MEANS, *supra* note 1, at 238.

7. For ease of reference, I refer to the board of directors and senior management collectively here as either "corporate management" or "the board." The board and senior management may perform different functions for most corporations; however, these distinctions are not central to the premise of this Article. In addition, I use the term "stakeholders" here broadly to mean any party with an economic interest in the corporation, including both shareholders and creditors.

8. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1262 (2008) (discussing the fiduciary duties of various corporate actors).

9. *See id.* at 1265.

10. The potential for shareholders and creditors to influence corporate management and adversely affect the rights of other corporate stakeholders is

Like shareholders, these entities are not employed by the corporation, may not have the corporation's best interests at heart, and may seek to influence corporate decisions primarily to further their own economic interests. Nevertheless, the law treats them differently.

The traditional roles of corporate shareholders and creditors may support the courts' willingness to designate the former, but not the latter, as corporate fiduciaries. Shareholders commonly are viewed as part of a corporation's inner circle, and their rights arise in part from a state's corporate code and related common law.[11] Their stock ownership in the corporation gives them the right to, among other things, elect directors and vote on certain fundamental corporate transactions. Shareholders' rights and insider status place them in a position to influence the decisions of corporate management. Creditors, on the other hand, are outsiders to the corporation, and their rights arise from commercial contracts with the corporation.[12]

But shareholders and creditors do not necessarily act in accordance with their traditional roles. Some creditors are negotiating for shareholder-like rights in their financial and other contracts with the corporation.[13] These creditors are seeking and obtaining the right to approve or veto fundamental corporate transactions, to appoint directors or observers to the board, and to retain professionals for the corporation.[14] Moreover, these rights may be triggered or invoked by creditors at a

not a new phenomenon. See, for example, BERLE & MEANS, *supra* note 1, at 78–84, for a discussion of creditor influence over Fox Films and the Fox Theatre Corporation and shareholder influence over the Standard Oil Company dating to the 1920s. Notably, Berle and Means suggested that the dispersed-ownership corporate model may place control over the corporation in the hands of a self-perpetuating board and, as a result, substantially weaken the control of those outside of corporate management. *Id.* at 84–88. They concluded that "[i]t is conceivable, therefore, that the problems of 'control' [relating to majority shareholders, minority shareholders exerting influence, etc.] here discussed may become academic within another generation." *Id.* at 246. Although self-perpetuating boards have emerged, they have not eliminated control opportunities for nonmanagement parties. *See, e.g.*, MATTEO TONELLO, HEDGE FUND ACTIVISM: FINDINGS AND RECOMMENDATIONS FOR CORPORATIONS AND INVESTORS 12 (2008) (discussing activist hedge funds as an example of creditors exerting control).

11. A corporation's articles and bylaws often are viewed as a contract between the corporation and its shareholders. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15–17 (1991); *see also infra* Part III.B.

12. *See* EASTERBROOK & FISCHEL, *supra* note 11.

13. TONELLO, *supra* note 10, at 11–15.

14. *Id.*

time when the corporation is experiencing financial distress; financial leverage may give these creditors even more control than the shareholders of a solvent corporation.[15] Consequently, any justification for distinguishing between controlling shareholders and controlling creditors in the fiduciary context may be disappearing.

Institutional investors, led primarily by hedge funds and private equity firms, are a driving force behind this emerging convergence in the roles of corporate shareholders and creditors.[16] These institutional investors are less inclined to be passive shareholders or simple commercial creditors. They approach both equity and debt investments in a corporation as profit-generating opportunities, and they are not satisfied with market-rate returns. Accordingly, they tend to be more aggressive with their equity and debt holdings, and they often pursue the same objectives with those holdings—e.g., management turnover, changes in management compensation or shareholder dividend policies, mergers or acquisitions, or even ownership control of the corporation.[17] Regardless of their position in the corporation's capital structure, these investors frequently are successful in their efforts to influence corporate matters.[18]

This Article analyzes the increasing similarities between controlling shareholders and controlling creditors and what steps, if any, courts and policymakers should take "to govern the result of controlling [stakeholder] action."[19] The term "controlling stakeholder" is used here broadly to include not only majority shareholders and debtholders but also activist minority shareholders and creditors.[20]

15. *See* Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1324, 1397–98 (2007) (discussing a recent Delaware Supreme Court decision regarding directors' duty to creditors during insolvency).

16. *See infra* Part II.C.

17. *See* TONELLO, *supra* note 10, at 11–15 (discussing some goals of activist hedge funds).

18. *See infra* notes 55–57 and accompanying text.

19. BERLE & MEANS, *supra* note 1.

20. Different stakeholders can exercise varying degrees of control and influence over corporate action at different points in time. For example, an activist shareholder or debtholder may hold only a minority position but may still seek to influence the day-to-day activities of the corporation similar to the traditional majority controlling shareholder. Alternatively, he may attempt to influence a specific transaction or operational decision. See *infra* Part III for a discussion of the activities of these stakeholders.

The traditional judicial response of imposing fiduciary duties on controlling shareholders is an appealing solution.[21] A fiduciary's primary duty in the controlled-transaction context is the duty of loyalty, which prohibits or subjects to heightened scrutiny transactions involving self-dealing or conflicts of interest by the fiduciary.[22] Treating all controlling stakeholders as fiduciaries may protect existing corporate value and noncontrolling interests in the corporation.

Professors Iman Anabtawi and Lynn Stout propose extending fiduciary duties to minority shareholders who "influence[] a particular corporate action . . . in a determinative way . . . ."[23] Their proposal would expand both the traditional concept of control under controlling shareholder fiduciary law and the transactions subject to fiduciary duties. Under their proposal, "shareholder fiduciary duties [would apply] . . . to any corporate transaction or strategy that provides one or more shareholders with a material, personal pecuniary benefit not shared by other shareholders."[24] This proposal could be extended to include controlling and activist creditors as well.

Invoking fiduciary law to govern the conduct of non-management parties, however, may not be a good fit. For example, does a shareholder, lender, bondholder, or other investor act in a fiduciary capacity? A fiduciary generally is defined as "someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence."[25] An investor typically invests in the stock or debt of a company for its own benefit and seeks to influence corporate action in a manner that furth-

21. *See* Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471–72 (Cal. 1969) (holding that majority shareholders owe fiduciary duties to minority shareholders).

22. A corporate fiduciary owes at least two primary fiduciary duties to beneficiaries, i.e., the duty of care and the duty of loyalty. *See infra* Part IV.A (discussing corporate fiduciary duties generally). In addition, some courts impose a duty of good faith as part of the duty of loyalty, rather than as an independent fiduciary duty. *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) ("The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element' i.e., a condition, 'of the fundamental duty of loyalty.'"). In the context of controlling stakeholders and controlled transactions, courts tend to focus on the duty of loyalty. See *infra* Part IV.A (discussing fiduciary duties of care and loyalty).

23. Anabtawi & Stout, *supra* note 8, at 1297 (proposing to extend controlling shareholder fiduciary duties to activist shareholders).

24. *Id.* at 1299.

25. William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181, 187 n.50 (2005); *see infra* Part IV.C.1.

ers its self-interest. A lender or supplier typically extends credit to a corporation to generate a profit for its own business. The law certainly can try to curb a stakeholder's self-interest by designating a controlling or activist stakeholder a fiduciary, but should it?

Likewise, does imposing fiduciary duties on stakeholders strengthen the corporation's governance or improve long-term corporate value? Investors and other stakeholders often have short-term perspectives on their investments in or business with the corporation.[26] They may not have the incentive or expertise to understand longer-term, value-generating opportunities for the corporation, even if they have the incentive and resources to monitor corporate performance. In contrast, the board should have the incentive and resources to identify, understand, and assess both short- and long-term value-maximizing opportunities for the corporation.

For example, a debtholder may exert significant influence over a corporation that is experiencing financial distress.[27] The debtholder may be able to dictate whether the corporation sells assets, makes distributions to shareholders, or obtains additional financing. The debtholder also may effectively direct the hiring of a financial advisor or chief restructuring officer. In these and like circumstances, the debtholder arguably is exercising its contractual rights and in turn controlling corporate action in a manner that increases its potential recovery on the outstanding debt.[28]

Rather than imposing fiduciary duties on this controlling debtholder or any stakeholder, I suggest that the board is in a better position to protect the corporation. The board can best manage risk and decline to bend to a stakeholder's potentially self-interested demands. In theory, this proposal seems simple and obvious. In practice, however, the challenge is the possibility of board passivity under the protection of the business judgment rule.[29]

26. Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Yet Come*, 59 BUS. LAW. 67, 78 (2003) (discussing investor perspectives on corporate value).

27. *Rich Pickings*, FUND STRATEGY, Apr. 3, 2006, at 20 (discussing the influence of "vulture investors" over distressed corporations).

28. *See* EASTERBROOK & FISCHEL, *supra* note 11.

29. The business judgment rule may apply in a stakeholder transaction dispute where, for example, the plaintiff cannot show the requisite level of domination or control by the stakeholder. *See infra* Part V.B.

One potential solution is to temper the protection afforded to boards by the business judgment rule in the limited context of stakeholder cases. A decision by a board that is influenced by a stakeholder (whether or not a controlling stakeholder) could be evaluated under a standard similar to that applicable in interested-director transactions.[30] I refer to this new standard as the "fairness proposal." This new standard would presume a conflict of interest for the entire board whenever it is approving a transaction out of the ordinary course of business that involves a particular stakeholder or group of stakeholders and that provides a unique benefit to those stakeholders at the expense of the corporation.[31] I refer to these types of transactions as "stakeholder transactions."[32]

The fairness proposal would evaluate whether a challenged stakeholder transaction is objectively fair to the corporation. Under the proposal, the board would bear the burden of showing that a stakeholder transaction satisfies the entire fairness standard, without the presumptive protection of the business judgment rule.[33] If the board fails to do so, the stakeholder transaction would be voidable and the directors would be subject to liability for breaching the duty of loyalty. Nevertheless,

30. This approach suggests two notable changes to existing standards governing interested-director transactions. First, most state corporate codes shift the burden of proof to the plaintiff upon a showing that, after full disclosure, the interested-director transaction was approved by a majority of disinterested directors or disinterested shareholders. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a)(1)–(2) (2008). Second, some courts apply business judgment protection to interested-director transactions if the transaction was approved by a majority of disinterested directors or shareholders. *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994) (discussing both burden-shifting and application of the business judgment rule in this context). My proposal does not incorporate either of these elements. *See infra* Parts V.B, VI.C.

31. *E.g.*, Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471–72 (Cal. 1969). The fairness proposal would not treat the alleged controlling shareholder or creditor as a fiduciary. *See infra* Part V.C.1. It also contemplates a broader definition of conflicted transactions. *See id.*

32. The definition of stakeholder transaction is central to the fairness proposal. *See infra* Part V.C.1. If a plaintiff fails to show the existence of a stakeholder transaction, existing law and, potentially, the business judgment rule would govern the transaction. *See id.*

33. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719–20 (Del. 1971) ("The standard of intrinsic fairness involves both a high degree of fairness and a shift in the burden of proof. Under this standard the burden is on [the controlling shareholder] to prove, subject to careful judicial scrutiny, that its transactions with [the corporation] were objectively fair." (citations omitted)); *see also infra* Part V.B (considering the relationship between the fairness proposal and the business judgment rule).

the fairness proposal would include procedural safeguards to protect directors from strike suits and to mitigate the potential for hindsight bias in any ultimate judicial review. For example, plaintiffs would bear the burden of production in establishing their prima facie case, and the law could impose a relatively short statute of limitations—e.g., three months after disclosure of the transaction—to foster contemporaneous review of the transaction.[34] In addition, the board may ease its burden by exposing the stakeholder transaction to a meaningful market test.[35]

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

In Part I, the Article explains the justifications for reexamining controlling stakeholder duties. It then explores the increase in stakeholder control and the similarities among controlling stakeholders in Parts II and III. This discussion focuses on the strategies of institutional investors as both shareholders and creditors and the typical theories of liability asserted against controlling stakeholders.

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

34. *See infra* Part V.A.
35. *See infra* note 243 and accompanying text.

I. A NEED FOR CHANGE

Historically, the law has treated corporate shareholders and creditors differently.[36] For example, directors and senior management of a solvent corporation do not owe fiduciary duties to bondholders or other creditors.[37] They do, however, owe duties to shareholders.[38] The different treatment accorded to shareholders and creditors frequently is justified by the contractual nature of the creditor-debtor relationship.[39] Nevertheless, as discussed in Part III, the line between shareholders and creditors is blurring.

Both shareholders and creditors have opportunities to ex-

36. BERLE & MEANS, *supra* note 1, at 279 (observing that the law imposes "a sharp dividing line" between shareholders and bondholders notwithstanding the economic similarities between the two). On the other hand, courts at times have treated shareholders and certain creditors—primarily bondholders—in a similar manner. *See* Jackson v. Ludeling, 88 U.S. (21 Wall.) 616, 622 (1874) (explaining with respect to bondholders that "[w]hen two or more persons have a common interest in a security, equity will not allow one to appropriate it exclusively to himself, or to impair its worth to the others").

37. *See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 94 (Del. 2007) (explaining that a solvent or nearly solvent corporation owes no duties to creditors); *see also* Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature." (citations omitted)); Hu & Westbrook, *supra* note 15, at 1324–26 (discussing courts' different treatment of boards' fiduciary duties to shareholders and creditors); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 818–27 (2008) (explaining boards' fiduciary duties to shareholders versus creditors and arguing against any expansion of such duties to creditors).

38. *See, e.g.*, *Gheewalla*, 930 A.2d at 101 ("When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."). Most courts and many commentators describe a board's objective as shareholder wealth maximization. *See, e.g.*, Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1977 (1991) (describing such wealth maximization as "the bedrock of corporate law"). The Michigan Supreme Court often is credited with first articulating this objective in *Dodge v. Ford Motor Co.* as follows: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end." 170 N.W. 668, 684 (Mich. 1919). Some commentators debate that characterization of corporate purpose. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 731 (2006) (explaining the debate regarding corporate purpose as shareholder wealth maximization and arguing that "[t]here is very little in corporate law that supports it and much that cuts against it").

39. *See infra* notes 87–89 and accompanying text.

ercise corporate control.[40] Hedge funds and other institutional investors are increasingly pursuing activist agendas as shareholders *and* as creditors. "Since 2003, in particular, the marketplace registered hundreds of instances of shareholder activism involving hedge funds; in nearly two-thirds of the cases, corporate management either immediately acquiesced in the funds' demands or . . . agreed to major concessions to meet the activists' expectations."[41] In addition, "[h]edge funds investing in distressed debt are increasingly aiming for control of company boards, seeking more from their holdings than just yield and capital gain."[42] The end result in either case is a controlling action that benefits the particular shareholder or creditor and that may or may not be fair to the corporation.

The face of "controlling" stakeholders and the nature of their controlling actions are changing. The law needs to address these changes. Professors Anabtawi and Stout have set forth one proposal in the controlling shareholder context.[43] I set forth an alternative proposal here. I share many of the concerns regarding activism expressed by Professors Anabtawi and Stout and others.[44] I grant greater deference, however, to the potential benefits of both shareholder and creditor activism and propose a broader solution that focuses on the constant entity in corporate transactions—the board.

II. THE ROLE OF CORPORATE STAKEHOLDERS

A. SEPARATION OF OWNERSHIP AND CONTROL

The stock ownership of most public corporations in the United States is widely dispersed, placing control over most corporate affairs in the hands of the board of directors and senior management.[45] State corporate codes generally provide

40. *See infra* Parts II.D, III.C.

41. TONELLO, *supra* note 10.

42. Gerard Wynn, *Hedge Funds Target Distressed Companies for Control*, REUTERS, Dec. 18, 2003, at http://www.longroadllc.com/_PDF/dec18_03.pdf.

43. *See* Anabtawi & Stout, *supra* note 8, at 1293–1303. Many commentators express concern regarding the strategies and activism of hedge funds, which can include empty voting, short-selling stock, and short-termism. *See infra* Part VI.B.

44. *See* Anabtawi & Stout, *supra* note 8, at 1283–92 (discussing issues with conflicted activist shareholders).

45. The issues and proposal discussed in this Article relate primarily to public corporations and private corporations that are not closely held. The dynamics of the typical closely held corporation may warrant separate consideration.

that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."[46] The board of directors routinely delegates the day-to-day operations of the corporation to senior management.[47] As a result, the board and senior management typically direct the business affairs of the corporation. Shareholders and other corporate stakeholders have little day-to-day input.[48]

The interests of corporate management and corporate stakeholders do not always align. Management's discretion over corporate affairs with minimal oversight from stakeholders presents opportunities for management to divert value from the corporation and its stakeholders.[49] Management's diversion of value may be intentional, to benefit management itself, or unintentional and simply the result of negligence, incompetence, or apathy.[50] In either situation, the separation of ownership from control of the corporation creates costs, commonly referred to as agency costs.[51] Existing scholarship provides a thorough analysis of the potential implications of these agency costs.[52]

B. THE MONITORING ROLE OF STAKEHOLDERS

Increased monitoring of corporate affairs by stakeholders—in particular, shareholders—may reduce agency costs.[53] Active

46. DEL. CODE ANN. tit. 8, § 141(a) (2007); *see also* MODEL BUS. CORP. ACT § 8.01(b) (2002).

47. *See* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 235 (2007) (describing the division of labor within a corporation).

48. *Id.*

49. *See* BERLE & MEANS, *supra* note 1, at 121–25 (discussing the costs imposed upon the corporation by the separation of corporate control and corporate ownership); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (explaining an economic theory of agency costs in corporate form).

50. *See, e.g.*, Illig, *supra* note 47, at 235–36 (discussing agency costs and the "collective action problem that leads inexorably to rational shareholder apathy").

51. *Id.*

52. *See generally* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737 (2001) (discussing the Berle and Means theory of agency costs and the scholarship devoted to the theory).

53. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 831–33 (1992) (discussing benefits to active shareholder monitoring and noting that "[s]hareholder monitoring is one strand in a web of imperfect constraints on corporate managers");

monitoring by stakeholders can encourage management to identify and pursue value-generating opportunities for the corporation and provide signals to other stakeholders and the market when management is acting otherwise.[54] This type of monitoring by stakeholders, however, is time-consuming and expensive.[55] The average individual shareholder has neither the resources nor the incentive (based on a cost-benefit analysis) to engage in active oversight.[56]

Institutional investors are in a different position than the average individual shareholder.[57] These investors often have the human and financial resources to monitor corporate management and performance.[58] Nevertheless, they may not have the incentive, or they may have potential conflicts of interest

John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1281–91, 1318–27 (1991) (discussing benefits of and impediments to shareholder monitoring of corporate management); Laura Lin, *The Information Content of a Bank's Involvement in Private Workouts*, 3 GEO. MASON INDEP. L. REV. 97, 108–13 (1994) (explaining signaling and monitoring role of banks in private workouts); Minh Van Ngo, *Agency Costs and the Demand and Supply of Secured Debt and Asset Securitization*, 19 YALE J. ON REG. 413, 427–28 (2002) (explaining creditors' experience with monitoring management under general and financial covenants in debt instruments); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 465 (1986) (suggesting that large shareholder monitoring increases profit expectations).

54. *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 841–43 (2001) (discussing role of monitoring in bank-centered and stock-market-centered capital markets and explaining that "[m]onitoring has two basic dimensions—monitoring insiders, to ensure that they don't steal the company's value from investors (shareholders or creditors), and monitoring management performance, to ensure that a company maximizes that value"); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1078–81 (1995) (discussing signals provided to the markets and corporate stakeholders by nonequity stakeholders, including decisions by financial institutions to enter into or exit a credit facility with the corporation).

55. Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 CHI.-KENT L. REV. 681, 691 (1989) ("Direct monitoring of managerial behavior and judicial enforcement of fiduciary duties are costly and imperfect tools for reducing those costs.").

56. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 95 (1985) (discussing costs of monitoring and impediments to monitoring by individual shareholders); Honabach & Dennis, *supra* note 55, at 691 (discussing market controls as alternatives to direct shareholder monitoring).

57. *See, e.g.*, Black, *supra* note 54, at 831–39 (explaining the potential of institutional investors to be effective corporate monitors).

58. *Id.*

that prevent them from filling the role of corporate monitor.[59] Most pension funds, mutual funds, and insurance companies remain passive corporate investors primarily because of potential conflicts of interest arising either from fiduciary duties owed by the funds to their beneficiaries or from an existing business relationship with the corporation.[60]

Hedge funds and private equity firms have the resources of other institutional investors, but do not encounter the same barriers to corporate monitoring.[61] These private funds generally are not subject to the same disclosure obligations and regulatory oversight imposed on traditional institutional investors.[62] Moreover, the general purpose of these private funds is to provide significant returns to investors in a relatively short period of time.[63] Investors are attracted to private funds because these funds claim to outperform traditional public markets.[64] Investors also pay significant management fees to the private funds to achieve these results.[65]

The profit expectation associated with private funds and

59. *See, e.g.*, *id.* at 849–73 (discussing impediments to institutional investor activism and monitoring, including potential conflicts of interest).

60. *But see* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 596–98 (1990).

61. *See, e.g.*, Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172, 175–77 (explaining influence of hedge funds and private equity firms on markets and noting that "[h]edge funds held an estimated $2.79 trillion in assets as of the close of 2007" and that private equity firms "domestically raised an estimated $302 billion in equity commitments in 2007"); *see also* Illig, *supra* note 47, at 272–74, 333–34 (discussing similarities between hedge fund and private equity fund activism and incentives for private funds to monitor corporate governance).

62. *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1382–84 (2007) (discussing distinctions between private funds and traditional institutional investors); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1062–70 (2007) (discussing the potential of hedge funds to act as effective corporate monitors).

63. *See, e.g.*, Bratton, *supra* note 62, at 1383 ("The tie that binds the hedge funds together, despite the variety of investment styles, is their promise to deliver above-market returns, a task that becomes harder and harder as more funds pursue the same strategies.").

64. *Id.*

65. *See, e.g.*, Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 828 (2008) ("Unlike mutual fund and pension fund managers, who receive management fees on the order of 0.5% to 3%, hedge fund managers receive performance rewards in the neighborhood of an additional 15%."); *see also* Illig, *supra* note 47, at 282–87 (discussing fee structures of private funds and the correlation between fees and activism).

the funds' fee structures provide incentive for private funds to be more than passive investors. Private funds are more willing than traditional institutional investors to take aggressive positions with management. As shareholders, private funds pursue changes in management personnel, management compensation packages, and operational strategies.[66] They may even seek a controlling ownership interest in, and representation on the board of, the corporation.[67] As debtholders, private funds pursue similar objectives, although the target of their efforts typically is the financially distressed corporation.[68]

The private funds' desire to achieve significant profits on a relatively short investment horizon raises concerns regarding their impact on long-term corporate value.[69] For that reason, many commentators view activism by private funds negatively and do not believe that these funds are appropriate corporate monitors.[70] I suggest that caution is warranted when evaluat-

66. *See* Kahan & Rock, *supra* note 62, at 1029 ("This activism takes a variety of forms, from public pressure on a portfolio company to change its business strategy, to the running of a proxy contest to gain seats on the board of directors, to litigation against present or former managers.").

67. For example, Pershing Square Capital Management initiated a proxy contest and proposed its own slate of directors for Target Corporation after Target's nomination committee rejected the hedge fund's candidate suggestions. *See* William A. Ackman, Letter to the Editor, BARRONS, May 26, 2009, http://online.barrons.com/article/SB124335446217554825.html?mod=article-outset-box. Pershing Square ultimately lost the proxy contest, and Target's shareholders reelected the existing board members. *See* Lauren Coleman-Lochner, *Target Holders Re-Elect Board, Reject Ackman Nominees (Update 2),* BLOOMBERG.COM, May 28, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=arVagGXDEY9A#.

68. *See* Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401 (1997) (discussing objectives of activist debtholders and analyzing their impact on corporate governance); *see also* STUART C. GILSON, CREATING VALUE THROUGH CORPORATE RESTRUCTURING 188–90 (2001) (describing the strategies of those who invest in distressed companies).

69. *See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 682–83 (2007) (discussing issue of short-termism in context of activist private funds); Kahan & Rock, *supra* note 62, at 1087–91 (observing that "[s]hort-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism" and positing potential responses to this critique of private fund activism).

70. *See, e.g.*, Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2016 (2002) ("In that environment, distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments."); *see also* Andrew M. Kulpa, *The Wolf in Shareholder's Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control*

ing the role of private funds in corporate governance. Nevertheless, I also suggest that they and similar investors have a productive role to play. As discussed further below, activist stakeholders challenging the conduct of *strong* management may enhance overall corporate performance.[71]

C. INCREASING ACTIVISM BY STAKEHOLDERS

Private funds and some traditional institutional investors are increasingly taking a more active role in corporate governance.[72] Private funds are more vocal in the proxy process, seeking a broad range of reforms from the corporation's capital structure to corporate governance matters.[73] They also use shareholder proposals and informal meetings with management to pursue their agendas.[74] Institutional investors have been relatively successful in facilitating corporate change through shareholder activism.[75] Examples of effective share-

and Governance, 6 U.C. DAVIS BUS. L.J. 78, 88–101 (2005) (explaining potential risks in hedge fund activism and advocating regulation of hedge fund activities).

71. I emphasize the need for strong management in this model because management must have the fortitude to evaluate objectively the proposals and pressures advanced by institutional investors. *See* Klick & Sitkoff, *supra* note 65, at 826 (noting, in context of a study suggesting that market controls are more effective monitors than controlling shareholders, that "a controlling shareholder, at least one whose agents are poorly motivated, provides less discipline against corporate agency costs than the takeover market"); *see also infra* Part V. For example, prior to its proxy contest with Target, Pershing Square Capital Management made several business proposals to Target's board and management, including the divestiture of Target's real estate holdings to a real estate investment trust. Target's board and management determined that the proposals were against Target's long-term best interests and resisted both the proposals and the subsequent director slate sponsored by Pershing Square. Although the prudence of the board's and management's business plan remains to be seen, their engagement in the process itself may hold value and result in more thoughtful business decisions. *See* Coleman-Lochner, *supra* note 67 ("The proxy contest 'has so accelerated my relationship with my most important shareholders . . . . I'm excited about reengaging in our business and taking it to a new level.'" (quoting Target's CEO, Gregg Steinhafel)).

72. *See* Klick & Sitkoff, *supra* note 65, at 826 ("The incidence of controlling shareholders and minority blockholders is increasing among public U.S. firms and is even more common among public companies in Europe.").

73. *See* TONELLO, *supra* note 10, at 27–28 (listing demands typically made by activist private funds, including expanding share repurchase programs, declaring special dividends, asset sales and mergers, declassifying the board and repealing shareholder rights plans, and other anti-takeover measures).

74. *See id.* at 28.

75. *See id.* at 32 ("In nearly two-thirds of the cases analyzed for the 2001–2006 period, corporate management either immediately acquiesced in the

holder activism include proxy fights and publicity campaigns against Applebee's International, Inc., General Motors Corporation, H.J. Heinz Company, McDonald's Corporation, Time Warner Inc., and Wendy's International, Inc.[76]

Institutional investors' activism as debtholders also is on the rise.[77] Investors can exert influence over the corporation in negotiating or renegotiating the covenants of the underlying debt instrument.[78] They can demand concessions or tighter covenants in response to a corporation's potential default under existing debt instruments. They can purchase a distressed corporation's existing debt and attempt to control the corporation's financial restructuring or bankruptcy.[79] Investors frequently invoke a combination of the foregoing strategies.

As in cases involving shareholder activism, institutional investors also are achieving their goals as activist debtholders.[80] Activist debtholders are changing management, suggest-

funds' demands or, after a phase of initial resistance and negotiation, agreed to major concessions to meet activists' expectations."); Alon Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63 J. FIN. 1729, 1736–39 (2008) (providing empirical data supporting findings of activism and success rates in hedge fund activism); *see also* Bratton, *supra* note 62, at 1409 ("The activists have an impressive record of success in the cases in the sample—so impressive that the record supports the proposition that they have shifted the balance of corporate power in the direction of outside shareholders and their financial agendas.").

76. TONELLO, *supra* note 10, at 34–37 (listing tactics used by hedge funds and outcome of activism at these and other corporate targets); *see also* Kahan & Rock, *supra* note 62, at 1030–35 (discussing activism at high-profile companies).

77. *See* Jay Krasoff & John O'Neill, *The Role of Distressed Investing and Hedge Funds in Turnarounds and Buyouts and How this Affects Middle-Market Companies*, 9 J. PRIVATE EQUITY (SPECIAL TURNAROUND MANAGEMENT ISSUE) 17, 17 (2006); Heidi Moore, *Distressed Debt Fundraising Hits Record*, FIN. NEWS ONLINE, July 13, 2007, http://www.efinancialnews.com/usedition/index/content/2448303706.

78. *See*, Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1217 (2006); George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 27 (2004).

79. *See, e.g.*, Hotchkiss & Mooradian, *supra* note 68, at 402–03 (finding that in an empirical study of 288 firms, "vulture investors" joined the board of directors of eighty firms, became CEO or chairman of twenty-seven firms, and gained control of forty-seven firms, often through the purchase of senior claims such as bank loans).

80. *See id.* at 411; Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, at 5–7 (Columbia Univ. Ctr. for Law & Econ., Working Paper No. 321; Northwestern Univ. Law School Law & Econ. Research Paper Series, Working Paper No. 08-16, July 9, 2008), *available at* http://ssrn.com/abstract=1081661; *see also* Michelle M. Harner, *Trends in Dis-*

ing asset sales, encouraging distressed corporations to retain restructuring professionals, and pursuing debt-for-equity exchanges that provide the debtholder with a meaningful, or perhaps controlling, ownership interest in the restructured corporation. Activist debtholders pursued one or more of these objectives in the restructurings of, for example, Allied Holdings, Inc., Bally's Total Fitness, Inc., Granite Broadcasting, Inc., Kmart Corporation, Radnor Holding Corp., and Werner Co.[81]

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

D. POTENTIAL PROBLEMS WITH CONTROL AND ACTIVISM

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

The story of the Mylan Labs/King Pharmaceuticals merger is well known primarily for the empty voting strategy invoked by Perry Capital.[82] This story also illustrates, however, the potential influence of shareholders who do not own a majority of the company's stock and are not necessarily seeking a direct

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tressed Debt Investing: An Empirical Study of Investors' Objectives, 16 AM. BANKR. INST. L. REV. 69, 84–86 (2008).

81. *See In re* Bally Total Fitness of Greater N.Y., Inc., No. 07-12395, 2007 WL 2779438, at *10 (Bankr. S.D.N.Y. Sept. 17, 2007); *In re* Radnor Holdings Corp., 353 B.R. 820, 829–30 (Bankr. D. Del. 2006); John R. Emshwiller, *Controversy, by the Truckload*, WALL ST. J., May 2, 2007, at A4 (referring to Allied Holdings); Ben Fidler, *Judge to Rule on Granite Plan*, DAILY DEAL (N.Y.), May 2, 2007; Mitchell Pacelle & Amy Merrick*, Behind Kmart Exit from Chapter 11: Investor's Big Bet*, WALL ST. J., May 6, 2003, at A1; Michael Roknick, *Werner Sale a Done Deal: Jobs Safe Under Terms of Sale*, HERALD (Sharon, Pa.), June 12, 2007, http://www.sharonherald.com/archivesearch/local_story_162214545.html/; *see also* Stephen M. Brecher et al., *"Alternative" Investment Managers and Bankruptcy: The Brave New World of Chapter 11*, 10 J. PRIVATE EQUITY (SPECIAL TURNAROUND MANAGEMENT ISSUE) 47, 48–49 (2007) (listing other examples of distressed debt investors' involvement in Chapter 11 cases, including Ormet Corporation, Foamex Corporation and Crescent Jewelers).

82. Spencer Klein et al., *A Cautionary Tale*, DAILY DEAL, Aug. 3, 2009, http://www.thedeal.com/newsweekly/community/a-cautionary-tale.php.

transaction with the company. Perry Capital and other King shareholders purchased Mylan stock and publicly supported the merger.[83] Carl Icahn, on the other hand, was long on Mylan stock and short on King stock and publicly opposed the merger, even making a bid for Mylan.[84] All of these shareholders were trying to influence the Mylan board to pursue the transaction that benefitted their individual economic interests, regardless of what that decision meant for the corporation and other shareholders.

When a corporation experiences financial distress, shareholders may try to encourage the corporation to buy back their stock or influence restructuring decisions. First Reserve Corp. pursued the former strategy with respect to its investment in James River Coal Co., and preferred stockholders, led by Harbinger Capital Partners Master Fund Ltd., pursued the latter strategy with respect to their investment in Granite Broadcasting Corp.[85] In these and similar instances, shareholders may try to steer the corporation in a direction that salvages their existing investment in the corporation or, perhaps, benefits their other holdings in the corporation itself or other portfolio companies.[86]

Moreover, creditors may try to exploit a corporation's financial distress to receive fees, payments, and other benefits not included in their original contracts. For example, in Granite Broadcasting, the majority noteholder, Silver Point Capital Finance, LLC, negotiated interim and postpetition financing for the corporation that yielded significant fees and greater collateral rights.[87] In addition, in connection with this financing,

83. *See id.*

84. *See* Andrew Ross Sorkin, *For a Takeover Artist, One Bluff Too Many?*, N.Y. TIMES, Nov. 28, 2004, at BU6.

85. *See In re* Granite Broad. Corp. 369 B.R. 120, 126 (Bankr. S.D.N.Y. 2007); Schnelling v. Crawford (*In re* James River Coal Co.), 360 B.R. 139, 150 (Bankr. E.D. Va. 2007).

86. Empty voting (i.e., the strategy of buying the voting rights, but not the economic rights associated with stock), shorting stock, and distressed arbitrage are a few examples of private fund investment strategies that can benefit the fund at the expense of the target corporation. *See* Donna Klinger, *Here Be Dragons*, NACUBO BUS. OFFICER, Apr. 2002, at 33, 33 ("Distressed arbitrage . . . involves purchasing publicly traded bonds of bankrupt companies and selling their common stock short."); *see also* HEDGE FUNDS 1, 1–17 (Jess Lederman & Robert A. Klein eds., 1995) (describing hedge fund investment strategies).

87. *See* Granite Broad. Corp., Current Report (Form 8-K), at 2–3 (Dec. 11, 2006); Granite Broad. Corp., Quarterly Report (Form 10-Q), at 7 (Nov. 14, 2006).

Silver Point obtained a majority ownership position in the reorganized company.[88] Other creditors used similar strategies to receive large refinancing payments and gain post-reorganization control in the Radnor Holding Corp. and Werner Co. chapter 11 cases, among others.[89] A creditor-motivated transaction may not align with the board's duty to implement a strategy that is in the corporation's best interests and that maximizes shareholder or creditor wealth, depending on the corporation's solvency.

III. SIMILARITIES AMONG CORPORATE STAKEHOLDERS

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

A. COMMON RIGHTS AMONG STAKEHOLDERS

The basic rights of shareholders include the right to elect directors, vote on certain fundamental corporate matters, receive dividends, and sell their stock.[90] The right to elect directors and vote on fundamental transactions commonly serves as a basis for shareholder control.[91] Shareholders owning or having influence over a majority of a corporation's voting stock can determine the composition of the board and whether key transactions are pursued.[92] Shareholders owning less than a majori-

88. *See In re Granite Broad. Corp.*, 369 B.R. at 125 (noting that Silver Point would appoint six of seven directors).

89. *See In re* Radnor Holdings Corp., 353 B.R. 820, 829–30 (Bankr. D. Del. 2006); Press Release, Werner Co., Werner Completes Asset Sale and Emerges from Bankruptcy (June 11, 2007), *available at* http://www.wernerladder.com.

90. *See generally* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 413, 424–27 (2006) (classifying shareholder rights generally into four categories—economic rights, control rights, information rights, and litigation rights—and analyzing the two fundamental rights of electing directors and selling shares).

91. *See id.* at 425 (noting that directors can often structure fundamental transactions so that no shareholder approval is necessary).

92. *See* Gradient OC Master, Ltd. v. NBC Universal, Inc., 930 A.2d 104, 130 (Del. Ch. 2007) ("[A] majority of shares owned by a shareholder [is] conclusive in finding that a controlling shareholder exists . . . .").

ty may still influence these matters if they control a sufficient amount of stock to elect at least one director or block the approval of key transactions.[93]

The basic rights of creditors vary depending on the terms of their contracts with the corporation. These contracts, however, can and often do grant creditors the right to veto fundamental corporate transactions, receive financial information, observe board meetings, and appoint one or more directors or convert the debt into equity under certain circumstances.[94] In

93. *See* Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1110–14 (Del. 1994) (determining that a 43.3% minority shareholder exercised control over a corporation's business affairs); Williamson v. Cox Commc'ns, Inc., No. 1663-N, 2006 WL 1586375, at *4–6 (Del. Ch. June 5, 2006) (holding that minority shareholders who had a right to designate one director each or to enter into commercial contracts with an investee were potentially liable as controlling shareholders); *In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 551–52 (Del. Ch. 2003) ("In practical terms, Carbonell holds a large enough block [approximately forty percent] of stock to be the dominant force in any contested Cysive election."); *see also* Rosener v. Majestic Mgmt., Inc. (*In re* OODC, LLC), 321 B.R. 128, 142 (Bankr. D. Del. 2005) (establishing sufficient connections between alleged "controlling shareholder" and board may be sufficient to impose fiduciary duties solely on that basis).

94. *See* Baird & Rasmussen, *supra* note 78, at 1236–42 (describing mechanics and use of debt covenants in context of debtor-in-possession loans); Kuney, *supra* note 78, at 46 ("[C]reditors willing to allow use of their cash collateral—which may encompass all of the debtor's liquid assets—or offering additional financing possess substantial bargaining power."). Loan covenants may give lenders the ability to approve changes to management or board personnel or require the corporation to hire a chief restructuring officer or similar executive. *See* Baird & Rasmussen, *supra* note 78, at 1233 (explaining the increasing use of chief restructuring officers and noting that "[a] change in managers or directors without the banks' explicit blessing is often an event of default under the loan covenants"); Rick Daysog, *Aloha Will Hire New Restructurer*, HONOLULU ADVERTISER, Sept. 20, 2005, at C1 ("Paul Singerman, Aloha's attorney, said in court papers that its lenders Abelco Finance LLC and Goldman Sachs Credit Partners LP have pushed for the hiring of a chief restructuring officer in exchange for continued funding."). In addition, lenders may obtain the explicit right to appoint directors either in connection with a small equity investment, typically in the form of preferred stock, or upon the corporation's failure to obtain certain financial or performance targets. *See, e.g.*, *In re* Radnor Holdings Corp., 353 B.R. 820, 829 (Bankr. D. Del. 2006) (describing how private equity firm purchased preferred stock and made substantial secured loans to corporations and received, among other consideration, warrants and the right to appoint one director and one observer to the board); Kelly Holman, *PCG Picks Up Piece of Lincoln Paper*, DAILY DEAL, Aug. 29, 2005, 2005 WLNR 13484692 (pointing out that a private equity firm invested $35 million in subordinated notes and equity and received, among other consideration, the right to appoint two directors to the corporation's board). Creditors also may obtain the right to appoint one or more of a reorganized corporation's directors in connection with a debt-for-equity exchange or similar restructuring. *See, e.g.*, *In re* Granite Broad. Corp., 369 B.R. 120, 125 (Bankr.

addition, the default, acceleration, and remedy provisions of these contracts may permit the creditor to foreclose on the corporation's assets or exert substantial influence over the corporation in the context of a forbearance agreement.

A shareholder's or creditor's relationship with the corporation may provide it with leverage in the parties' negotiations. In general, the exercise of contractual rights granted by the corporation to a shareholder or creditor will not constitute the degree of control necessary for controlling stakeholder duties.[95] A plaintiff may, however, use contract terms as evidence of excessive control by the shareholder or creditor over the corporation and its affairs.[96] "[C]ontrol rights in a contract may contribute to a finding that an entity was a controlling shareholder, and such rights constitute another factor that should be considered in determining whether defendants had actual control over a company."[97]

Like shareholders, creditors also have economic rights with respect to their corporate debtors.[98] The corporation must repay the loan amount or pay for the services or goods provided under the parties' contracts. Moreover, the corporation may be obligated under the applicable agreements to pay interest on the loan amounts, as well as fees and costs.[99] Many creditors also

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S.D.N.Y. 2007) ("[The debtors' prepetition lender] will also be able to appoint six of seven directors of the reorganized Debtors.").

95. *See* Nisselson v. Softbank AM Corp. (*In re* Market XT Holdings Corp.), 361 B.R. 369, 391 (Bankr. S.D.N.Y. 2007) ("[A] significant shareholder, who exercises a duly-obtained contractual right that somehow limits or restricts the actions that a corporation otherwise could take, does not become, without more, a 'controlling shareholder' for that particular purpose." (quoting Superior Vision Servs., Inc. v. Reliastar Life Ins. Co., No. 1668-N, 2006 WL 2521426, at *5 (Del. Ch. Aug. 25, 2006))).

96. See Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 792 (Bankr. M.D. Tenn. 2005), for an example of a trustee in a bankruptcy case alleging that certain creditors' preexisting relationships with a corporate debtor allowed them to negotiate and maintain below-market contracts to their significant benefit. See Williamson v. Cox Commc'ns, Inc., No. 1663-N, 2006 WL 1586375, at *5 (Del. Ch. June 5, 2006) for a case in which the court opined that alleged leverage by shareholders over commercial contract negotiations with the corporation may help establish the shareholders' controlling person duties.

97. *Nisselson*, 361 B.R. at 391.

98. *See supra* Part I (acknowledging the economic similarities between shareholders and bondholders); *see also* BERLE & MEANS, *supra* note 1, at 279–80 (noting that shareholders and bondholders "may be regarded as a hierarchy of individuals all of whom have supplied capital to the enterprise, and all of whom expect a return from it").

99. *See, e.g.*, Kuney, *supra* note 78, at 56–57 (discussing pricing and fees

have the ability to sell their debt contracts with the corporate debtor. Active markets exist for secured debt, bonds, and even trade debt, particularly when the corporation experiences financial distress.[100]

In some instances, creditors may possess more rights than shareholders with respect to the corporation, including more control rights.[101] A creditor's control and opportunities for control increase as a corporation's financial situation deteriorates. A potential default under a loan agreement or major supply contract can have a devastating and rippling effect on a corporation's business. A creditor may hold substantial leverage in negotiations with a corporation under these circumstances.[102]

in debtor-in-possession loans); *see also* James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 139–49 (2004) (describing fees and costs generally associated with secured credit).

100. *See* FRANÇOIS-SERGE LHABITANT, HEDGE FUNDS: MYTHS AND LIMITS 7–21 (2002) (discussing markets for debt claims); Sandeep Dahiya et al., *Bank Borrowers and Loan Sales: New Evidence on the Uniqueness of Bank Loans*, 76 J. BUS. L. 563, 563–64 (2003) (discussing markets for bank debt); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1685–89 (1996) (discussing market for trade claims).

101. *See* Silver Point Finance (i) Response to Certain Objections to Confirmation of Debtors' Plan of Reorganization and (ii) Joinder in (a) Creditors' Committee's Objection to Claims of Bartholomew Palmisano, Sr. and (b) Creditors Committee's Motion to Designate Palmisano's Vote at 2–18, *In re* OCA, Inc., No. 06-10179(B) (Bankr. E.D. La. Sept. 1, 2006) [hereinafter Silver Point Response] (explaining role of controlling shareholder and director in corporation prior to bankruptcy and referencing creditor's ability to encourage his resignation and to obtain a controlling ownership interest in the reorganized corporation); *see also* Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 791–93 (Bankr. M.D. Tenn. 2005) (explaining significant leverage obtained by the debtor's customers through prepetition commercial and financing contracts); Baird & Rasmussen, *supra* note 78, at 1217 ("These loan agreements define defaults in ways that give creditors as much control over the board and its decisions as shareholders. Indeed, in the limit, these covenants can obliterate the difference between debt and equity.").

102. Accordingly, creditors negotiating a forbearance or restructuring agreement with a corporation frequently request and obtain control covenants similar to the following:

> 7.16 Financial Advisors. The Borrower shall employ and maintain the services of a financial adviser acceptable to the Lenders . . . .
>
> 7.17 Management. The Borrower shall employ and maintain such employment of an individual or individuals acceptable to the Lenders to the positions of Executive Vice President and Chief Administrative Officer . . . .
>
> 8.4 Disposition of Assets. [Subject to certain exceptions, each] of the Credit Parties will not, and will not permit or cause any of its Subsidiaries to sell, assign, lease, convey, transfer or otherwise dispose of . . . all or any portion of its assets, businesses or properties . . . .

Silver Point Response, *supra* note 101, at exhibit F.

B. DIFFERENT BASES FOR STAKEHOLDERS' RIGHTS

Both shareholders and creditors are viewed as having a contractual relationship with the corporation.[103] The shareholders' contract is based on applicable state law and the corporation's articles of incorporation.[104] This basic contract may be supplemented by individual agreements between the corporation and individual shareholders. As suggested above, the creditors' contract depends on the nature of the relationship between the corporation and the creditor and largely is the product of negotiation between the parties.

The statutory basis of the shareholder contract leaves it incomplete in many respects. These gaps are filled by common law, including fiduciary duty law.[105] In the context of the controlling shareholder, fiduciary duty law can be viewed as protecting minority holders who cannot contract for their own protection.[106]

The genesis of the creditor contract is notably different. In most instances, the key terms of the contract, including the respective rights of the parties upon default, are specifically negotiated by the parties.[107] The corporation and the creditor are presumed to be sophisticated business entities capable of protecting their interests in the negotiation and ultimate terms of the contract. Courts will enforce the parties' contract but will rarely rewrite or supplement the contract terms.[108]

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

104. *See* EASTERBROOK & FISCHEL, *supra* note 11, at 5–6.

105. *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 433 (1993).

106. *See* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 635 (1997) (noting that minority shareholders receive greater protection through fiduciary law than through contract law).

107. *But see* Mitchell, *supra* note 103, at 1179 (explaining that bondholders typically do not participate in the negotiation of the bond contract).

108. *See, e.g.*, Ernie Haire Ford, Inc. v. Ford Motor Co., 260 F.3d 1285, 1290–91 (11th Cir. 2001) ("[I]t is well settled that 'when the terms of a voluntary contract are clear and unambiguous, . . . the contracting parties are

The different degrees of contractual leverage and protection afforded shareholders versus creditors may justify treating the control rights and duties of these stakeholders differently.[109] Nevertheless, the increasing use of control covenants and hybrid financial instruments, activism by shareholders and creditors, and liquidity in both the equity and debt markets may lessen the practical importance of any contractual differences.[110]

C. SIMILARITIES IN ACTIVIST ACTIVITIES

The rights held by shareholders and some creditors allow activist investors to pursue their agendas as shareholders, creditors, or both. Activist shareholders and activist creditors may try to influence the composition of the board, the sale of assets, a takeover of the corporation, or other significant transaction.[111]

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bound by those terms, and a court is powerless to rewrite the contract to make it more reasonable or advantageous for one of the contracting parties.'" (omission in original)) (quoting Emergency Assocs. of Tampa, P.A. v. Sassano, 664 So. 2d 1000, 1003 (Fla. Dist. Ct. App. 1995)); Cruden v. Bank of New York, 957 F.2d 961, 976 (2d Cir. 1992) ("A court may neither rewrite, under the guise of interpretation, a term of the contract when the term is clear and unambiguous, nor redraft a contract to accord with its instinct for the dispensation of equity upon the facts of a given case.") (citation omitted).

109. *See, e.g.*, Velasco, *supra* note 90, at 443 ("The difference is in the terms of their contracts: where the shareholder has the right to all the residual profits of the business, if any, the bondholder has the right to receive a specified return, and no more."). At least one commentator has suggested subjecting both controlling shareholders and controlling creditors to fiduciary duties under the standards applicable to controlling shareholders. *See* Jeffrey John Haas, *Insights into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders*, 135 U. PA. L. REV. 1321, 1345–59 (1987).

110. Commentators evaluating corporate models other than the shareholder-primacy model often acknowledge the similar circumstances of shareholders and creditors. *See, e.g.*, Theresa A. Gabaldon, *Like a Fish Needs a Bicycle: Public Corporations and Their Shareholders*, 65 MD. L. REV. 538, 542 (2006) (explaining that, under options theory, "once a firm has issued debt, debtholders and holders of equity both share contingent control and bear residual risk"); Mitchell, *supra* note 103, at 1171–77 (discussing roles of shareholders and bondholders and corresponding management fiduciary duties); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 804–05 (2007) (discussing team production model of corporate governance and noting that "while shareholders may share in the wealth when the corporation does well and suffer when the firm does poorly, so may employees, creditors, and other stakeholders"); *see also* BERLE & MEANS, *supra* note 1, at 120 ("When speaking of the ownership of all corporations, the bondholders are often included with the stockholders as part owners.").

111. *See supra* Part II.C.

For example, shareholders of Yahoo! Inc. (Yahoo) began campaigning for a new CEO and board prior to the company's 2008 annual meeting.[112] Shareholders led by activist investor Carl Icahn reportedly were upset over the Yahoo board's handling of a proposed bid for the company by Microsoft Corp.[113] In the months leading up to the annual meeting, several of Yahoo's top executives resigned and Yahoo announced a significant strategic and operational restructuring.[114]

Similarly, senior lenders led by Silver Point Capital and Carl Icahn and bondholders of Tropicana Entertainment Holdings LLC lobbied the bankruptcy court presiding over Tropicana's reorganization to remove its CEO from "all management and directorial decisions."[115] Tropicana's CEO voluntarily resigned his position but retained his equity position in the company. Tropicana also appointed a new CEO and five-member board.[116] These changes, however, did not satisfy Tropicana's bondholders, who continued to pursue the appointment of a trustee for the company.

In both cases, stakeholders influenced key decisions by boards. The management changes at Yahoo and Tropicana ultimately may serve the interests of the corporations and their stakeholders. The results largely will depend on future board decisions regarding operations and, in Tropicana's case, its capital structure. Activist stakeholders also may influence other types of board decisions, including proposed mergers, asset sales, or recapitalizations.[117] These types of decisions have a more immediate impact on corporate interests and, consequently, may trigger disagreements among the stakeholders themselves.[118]

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112. Yi-Wyn Yen, *Yahoo Exodus Adds to Yang's Burden*, CNNMONEY, June 20, 2008, http://money.cnn.com/2008/06/20/technology/yahoo_yang.fortune/index.htm.

113. *Id.*

114. *Id.*

115. Donald Wittkowski, *Tropicana Job-Cutter Yung Quits CEO Post*, PRESS OF ATLANTIC CITY, June 10, 2008, at C1.

116. *Id.* The senior lenders ultimately purchased Tropicana's assets in the Chapter 11 case by credit bidding their $200 million of debt. *See* Morgan Bettex, *Lenders Get Tropicana Casino in $200 Million Bargain*, LAW360, June 12, 2009, http://www.law360.com/articles/106267. The senior lenders were the only bidders and will own and control the Tropicana assets upon the closing of the sale. *Id.*

117. *See supra* Part II.C.

118. *See generally* Kurt F. Gwynne, *Intra-Committee Conflicts, Multiple Creditors' Committees, Altering Committee Membership and Other Alternatives*

D. CONTROL LIABILITY

The identity and motivations of an alleged controlling stakeholder are relevant to an analysis of existing law. A controlling shareholder generally is defined as one who "exercises a controlling influence over the management or policies of the corporation or the transaction or conduct in question by virtue of the person's position as a shareholder."[119] A controlling shareholder also includes any person or entity that owns a majority of the corporation's voting stock.[120] A controlling creditor generally is defined as one who "exercises unreasonable or excessive control over its borrower" or customer.[121]

A shareholder or creditor exercising excessive control over corporate affairs may be subject to liability for breaching a fiduciary duty to the corporation and its stakeholders.[122] Noncontrolling stakeholders, either in a direct or derivative capacity, are not hesitant to assert breach of fiduciary duty claims against alleged controlling stakeholders. This type of fiduciary litigation commonly includes claims for aiding and abetting breaches of fiduciary duty and breaches of fiduciary duty by at least certain board members with ties to the alleged controlling stakeholder.[123] It also may include claims for fraud, misrepre-

for Ensuring Adequate Representation Under Section 1102 of the Bankruptcy Code, 14 AM. BANKR. INST. L. REV. 109 (2006) (discussing potential conflicts among committee members and their impact on Chapter 11 cases).

119. 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.10(a)(2) (1994).

120. *Id.* § 1.10(a)(1).

121. Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 809–11 (Bankr. M.D. Tenn. 2005) (discussing controlling creditor duties under Delaware, New York, and Tennessee law).

122. *See infra* Part IV.

123. *See infra* notes 249, 268; *see also* Nisselson v. Softbank AM Corp. (*In re* MarketXT Holdings Corp.), 361 B.R. 369, 391 (Bankr. S.D.N.Y. 2007) (action against shareholder and primary lender); Schnelling v. Crawford (*In re* James River Coal Co.), 360 B.R. 139, 147–48 (Bankr. E.D. Va. 2007) (action against shareholder); Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners (*In re* Radnor Holdings Corp.), 353 B.R. 820, 826 (Bankr. D. Del. 2006) (action against shareholder and primary lender); Official Comm. of Unsecured Creditors of Lois/USA, Inc. v. Conseco Finance Servicing Corp. (*In re* Lois/USA, Inc.), 264 B.R. 69, 131 (Bankr. S.D.N.Y. 2001) (action against primary lenders); Williamson v. Cox Commc'ns, Inc., No. Civ.A.1663-N, 2006 WL 1586375, at *3 (Del. Ch. June 5, 2006) (action against large shareholders and contract parties). The discussion in this Article of fiduciary duty claims against creditors includes those claims that generally are characterized as lender liability claims. *See generally* 1 GERALD L. BLANCHARD, LENDER LIABILITY (2d ed. 2008) (explaining various causes of action asserted as lender liability claims). Nevertheless, under the fairness proposal,

sentation, alter ego, equitable subordination, unjust enrichment, or deepening insolvency, among others.[124]

Controlling stakeholders may face litigation for their conduct, but court-imposed fiduciary liability is rare. Some courts are reluctant to impede the immunity granted to shareholders under state common law and statutory law.[125] Even courts that are inclined to impose fiduciary duties on a controlling stakeholder generally set a high bar for plaintiffs, particularly in the nonshareholder context.[126] No state imposes fiduciary duties on noncontrolling stakeholders. Many controlling stakeholder cases are dismissed or settled prior to trial.[127]

Consequently, a cost-benefit analysis may explain, in part,

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breach of contract, fraud, misrepresentation, and similar claims that also frequently fall within the rubric of lender liability would remain viable causes of action against creditors. *Id.*

124. *See supra* note 123.

125. *See Schnelling*, 360 B.R. at 173-74 (requiring plaintiff to show elements sufficient to pierce the corporate veil in order to impose liability against controlling shareholder and noting that "'[a] refusal to recognize the ordinary immunity of stockholders is not only overturning a basic provision of statutory or common law, but is also contrary to a vital economic policy underlying the whole corporate concept'" (quoting Beale v. Kappa Alpha Order, 64 S.E.2d 789, 797–98 (Va. 1951))). This general concern also underlies the principle that minority shareholders, absent control, owe no duties to the corporation. *See, e.g.*, US Airways Group v. British Airways PLC, 989 F. Supp. 482, 494 (S.D.N.Y. 1997) (opining that a claim of vicarious liability against a minority holder "would completely undermine Delaware corporate law, which limits such fiduciary duty to majority and controlling shareholders").

126. *See infra* Parts IV.A and IV.B; *see also* Pentech Pharms., Inc. v. Par Pharm., Inc., No. 04-C-3149, 2004 WL 2390088, at *3 (N.D. Ill. Oct. 21, 2004) ("Generally, New York courts are loath to recognize the existence of a fiduciary relationship between contracting sophisticated parties to a business transaction where the relationship is not created explicitly in a contract." (citing cases interpreting New York law)); Price v. Wells Fargo Bank, 261 Cal. Rptr. 735, 740 (Ct. App. 1989) ("A debt is not a trust and there is not a fiduciary relation between debtor and creditor as such." (quoting Downey v. Humphreys, 227 P.2d 484, 490 (Cal. Ct. App. 1951))).

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

why stakeholders continue to pursue and exert control over corporate affairs. The objective of the controlled conduct typically benefits the controlling stakeholder either exclusively or on a pro rata basis with other stakeholders.[128] Moreover, where the benefit is exclusive, the controlling stakeholder's risk of liability is low. Controlled transactions typically are good business for the controlling stakeholder.

Controlled transactions may or may not be good business, however, for the corporation. Controlled transactions are often abusive; the corporation and noncontrolling stakeholders may be injured in the process. For these reasons, some regulation of controlled transactions is necessary. The remainder of this Article analyzes potential solutions to control issues, including increased controlling stakeholder duties and stricter board accountability.

IV. CORPORATE STAKEHOLDERS AND FIDUCIARY DUTIES

The foundation of controlling stakeholder duties is fiduciary law.[129] Existing law designates certain controlling stakeholders as corporate fiduciaries. As such, these stakeholders owe a duty of undivided loyalty to the corporation and, in some instances, minority holders.[130]

The fiduciary label, however, is inapt. Modern corporate investment practices do not contemplate or create a trust relationship among investors. Principles of limited liability and contract rights conflict with fiduciary notions,[131] which may explain the stringent evidentiary bar employed by courts in the controlling-creditor context. As a result, the imposition of controlling stakeholder fiduciary duty is an uncertain and, at times, an underinclusive remedy to address potential abuse in

128. *See supra* Part II.C.

129. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306 (1939).

130. Some courts suggest that controlling shareholders owe their primary fiduciary duty to other shareholders. *See, e.g.*, Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R. Co., 417 U.S. 703, 716 n.13 (1974) ("It is settled law that the fiduciary duty owed by a controlling shareholder extends primarily to those who have a tangible interest in the corporation."); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) ("The controlling stockholder owes the corporation a fiduciary obligation—one 'designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.'" (quoting *Pepper*, 308 U.S. at 307)).

131. *See infra* Part IV.C.

controlled transactions.[132]

A. TRADITIONAL CONTROLLING SHAREHOLDER DUTIES

In general, shareholders do not owe a fiduciary duty to the corporation, its shareholders, or its other stakeholders.[133] "Moreover, it is well established law that nothing precludes . . . a [share]holder from acting in its own self-interest."[134]

These general principles do not apply, however, if the shareholder owns a majority of the corporation's stock or exercises actual control over corporate affairs.[135] A majority or controlling shareholder owes a fiduciary duty to the corporation and its minority shareholders.[136] Although some courts suggest that a controlling shareholder owes both a duty of care and a duty of loyalty,[137] the majority hold that controlling shareholder duties fall within the duty of loyalty. The duty of loyalty requires only that the controlling shareholder act fairly towards the corporation and minority shareholders. "[I]t does not, absent a showing of culpability, require that directors or controlling shareholders sacrifice their own financial interest in the

132. Controlling stakeholder fiduciary duty could also be overinclusive to the extent that majority ownership or pursuing self-interest alone is sufficient to impose duties on a stakeholder. *See infra* Part IV.C.

133. *See, e.g.*, Gradient OC Master, Ltd. v. NBC Universal, Inc., 930 A.2d 104, 130 (Del. Ch. 2007) ("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.").

134. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987).

135. *See, e.g.*, *Gradient OC Master*, 930 A.2d at 130; *see also* 1 AM. LAW INST., *supra* note 119, § 1.10(a); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003) (summarizing and analyzing existing controlling shareholder fiduciary duty law).

136. *See*, *e.g.*, Wheeler v. Abilene Nat'l Bank Bldg. Co., 159 F. 391, 393–94 (8th Cir. 1908) ("The holder of the majority of the stock of a corporation has the power, by the election of biddable directors and by the vote of his stock, to do everything that the corporation can do . . . . This devolution of unlimited power imposes on a single holder of the majority of the stock a correlative duty, the duty of a fiduciary or agent, to the holders of the minority of the stock . . . ."); Anabtawi & Stout, *supra* note 8, at 1269 ("[B]ecause shareholders generally elect and remove directors by majority vote, a shareholder who owns more than 50% of the company's outstanding shares has become the archetypal 'controlling' shareholder.").

137. *See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., Civ. A. No. 8358, 1991 WL 111134, at *19 (Del. Ch. June 24, 1991) ("[W]hen a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of the corporation."), *aff'd in part, rev'd on other grounds sub nom.* Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993).

enterprise for the sake of the corporation or its minority shareholders."[138]

The notion of a controlling shareholder's fiduciary duties dates to the nineteenth century and is based on the exercise of control over common property owned jointly by the controlling shareholder and the minority or noncontrolling shareholders.[139] "It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation."[140] The United States Supreme Court has described the powers of controlling shareholders as "powers in trust."[141]

Notwithstanding the breadth suggested by the trust analogy, courts generally exercise restraint in imposing fiduciary duties on controlling shareholders. As discussed above, courts require a plaintiff to allege majority ownership or "domination by a minority shareholder through actual control of corporation conduct."[142] Courts also tend to limit controlling shareholders' fiduciary duties to certain transactions, primarily minority freeze-out transactions and transactions in closely held corporations.[143] Consequently, a controlling shareholder's risk of facing actual liability for a breach of fiduciary duty is relatively low.

B. TRADITIONAL CONTROLLING CREDITOR DUTIES

Like shareholders, creditors generally do not owe any fiduciary duties to their corporate debtors or the debtors' other stakeholders.[144] This default rule is based on the contractual

138. Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 598 (Del. Ch. 1986).

139. *See, e.g.*, Menier v. Hooper's Tel. Works, (1874) 9 Ch. App. 350, 353–54 (holding that the majority cannot profit at the expense of the minority); *see also* Jones v. Missouri-Edison Elec. Co., 144 F. 765, 771 (8th Cir. 1906) (holding that although a shareholder's duties generally are contractual, shareholders have a joint interest in the same property and must not do anything to impair title to that property).

140. S. Pac. Co. v. Bogert, 250 U.S. 483, 492 (1919).

141. Pepper v. Litton, 308 U.S. 295, 306 (1939).

142. Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989).

143. *See, e.g.*, Anabtawi & Stout, *supra* note 8, at 1271–74; Gilson & Gordon, *supra* note 135, at 789–803.

144. "Existence of a debtor-creditor relationship alone is not sufficient to establish a fiduciary relationship." Cont'l Bank N.A. v. Quality Mfrs., Inc., No. 90-C-1164, 1990 WL 119503, at *8 (N.D. Ill. Aug. 10, 1990) (citing Vargas v. Esquire, Inc., 166 F.2d 651 (7th Cir. 1948)); *see also* Capitol Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (*In re* 604 Columbus Ave. Realty Trust),

nature of the creditor-debtor relationship.[145] The rule extends to situations where the creditor also may hold an equity interest in the corporate debtor. "[O]ne who may be both a creditor and a fiduciary (e.g., a director or controlling shareholder) does not by reason of that status alone have special limitations imposed upon the exercise of his or her creditor rights."[146]

A creditor nonetheless may assume a fiduciary role with respect to its corporate debtor if it exercises control over the debtor.[147] Courts recognize that creditors obtain certain types of control in the normal creditor-debtor relationship. For example, contractual provisions imposing reporting requirements on a debtor or granting a creditor veto rights over certain corporate actions are common features of most lending relationships.[148] Accordingly, courts generally impose fiduciary duties on a creditor in only those limited circumstances where the

968 F.2d 1332, 1361 n.25 (1st Cir. 1992) ("As a general rule lenders are not fiduciaries when it comes to collection on their claims."); Smith v. GMAC Mortgage Corp., No. 5:06CV125-V, 2007 WL 2593148, at *5 (W.D.N.C. Sept. 5, 2007) (explaining that "[i]t is well established that 'no fiduciary relationship exists between mutually interdependent businesses with equal bargaining positions who dealt at arms-length'" including corporations and their creditors).

145. Sharp Int'l Corp. v. State St. Bank (*In re* Sharp Int'l Corp.), 403 F.3d 43, 52 n.2 (2d Cir. 2005) ("The legal relationship between a borrower and a bank is a contractual one of debtor and creditor and does not create a fiduciary relationship between the bank and its borrower." (quoting Bank Luemi Trust Co. of N.Y. v. Block 3102 Corp., 580 N.Y.S.2d 299, 299 (App. Div. 1992)).

146. Odyssey Partners v. Fleming Cos., Civ. A. No. 14770, 1996 WL 422377, at *3 (Del. Ch. July 24, 1996) (citing Solomon v. Pathe Commc'ns Corp., Civ. A. No. 12563, 1995 WL 250374 (Del. Ch. Apr. 21, 1995), *aff'd* 672 A.2d 35 (Del. 1996)).

147. Courts have suggested that "representation on the borrower's board of directors, [or influencing] decisions as to hiring and firing, decisions as to the disposition of assets, and/or as to the shutdown of any lines of business" may impose fiduciary duties on creditors. Official Comm. of Unsecured Creditors of Lois/USA, Inc. v. Conseco Fin. Servicing Corp. (*In re* Lois/USA, Inc.), 264 B.R. 69, 131 (Bankr. S.D.N.Y. 2001) (denying breach of fiduciary duty claim against lenders).

148. *See, e.g.*, Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 701 (5th Cir. 1990) ("Through its loan agreement, every lender effectively exercises control over its borrower to some degree." (internal quotation marks omitted)); Harris Trust & Sav. Bank v. Keig (*In re* Prima Co.), 98 F.2d 952, 966–67 (7th Cir. 1938) (lender's right to approve a contract between the debtor corporation and a third party was not sufficient to impose fiduciary duties); Schwan's Sales Enters. v. Commerce Bank & Trust Co., 397 F. Supp. 2d 189, 197 (D. Mass. 2005) (evidence that the lender directed hiring and firing of a debtor's management was not sufficient to impose fiduciary duties); *Cont'l Bank*, 1990 WL 119503, at *8 (unsupported assertions of right to inspect confidential financial statements insufficient to impose fiduciary duties).

creditor assumes the role of the debtor's management.[149]

C. CHALLENGES IN THE APPLICATION OF TRADITIONAL CONTROLLING STAKEHOLDER DUTIES

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

1. Controlling Stakeholders as Fiduciaries

"The term 'fiduciary' is derived from the Latin 'fiduciarius,' denoting a trustee."[150] American fiduciary law has its roots in Roman and English law, which treated persons holding "the character of a trustee, or character analogous thereto" as fiduciaries.[151] The original purpose of fiduciary law was to prevent persons placed in positions of trust from abusing those positions for personal gain or otherwise.[152]

Early fiduciary law focused on the purpose underlying the relationship between the parties. An individual was characterized as a fiduciary for another where that individual was entrusted with property of a third party and the third party relied on the expertise and judgment of the individual with respect to all matters concerning the property.[153] Similarly, an individual

149. *See, e.g.*, Pension Trust Fund for Operating Eng'rs v. Fed. Ins. Co., 307 F.3d 944, 955 (9th Cir. 2002) ("[A] lender . . . owes a fiduciary duty to a borrower when it *excessively* controls or dominates the borrower." (emphasis added)); Nisselson v. Ford Motor Co. (*In re* Monahan Ford Corp.), 340 B.R. 1, 40–41 (Bankr. E.D.N.Y. 2006) (same).

150. ERNEST VINTER, A TREATISE ON THE HISTORY AND LAW OF FIDUCIARY RELATIONSHIP 1 (2d ed. 1955) (1932).

151. *Id.*

152. *Id.* at 2 ("The doctrine of fiduciary relationship is a doctrine of equity, the rule being that a person must not take advantage of that relation to obtain a gift or other benefit to himself."); *see also* Cally Jordan, *The Conundrum of Corporate Governance*, 30 BROOK. J. INT'L L. 983, 1013 (2005) (explaining the origins of trustees' fiduciary duties); Frank Partnoy, *Financial Innovation in Corporate Law*, 31 J. CORP. L. 799, 801–02 (2006) (summarizing the evolution of fiduciary law and the origins of trusteeship).

153. *See, e.g.*, Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046 (1991) ("In any [form of fiduciary duty], a beneficiary entrusts a fiduciary with control and management of an asset."); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 800 (1983) ("[O]ne party to a fiduciary relation (the *entrustor*) is dependent on the other (the fiduciary).").

charged with managing the affairs of a third party who was otherwise incapable of doing so was characterized as a fiduciary.[154] Accordingly, trustee- and guardianships were among the first positions of trust identified as fiduciary roles.[155]

In many ways, early fiduciaries were objective managers of the property within their trust and control. Trustees and guardians did not have a proprietary interest in the subject property, and fiduciary law generally prohibited them from obtaining any such interest.[156] In fact, some courts and commentators originally suggested that trustees, as fiduciaries, could not be compensated for their services.[157]

Courts have since designated other categories of fiduciaries, including agents in the principal-agent relationship, directors and senior officers in the corporate context, and partners in the partnership context. These fiduciaries exhibit traits similar, but not identical, to trustees. For example, agency is defined as "the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."[158] Directors and senior officers manage the affairs of the corporation for the benefit of the corpora-

154. *See* Frankel, *supra* note 153, at 800 ("By definition, the entrustor becomes dependent because he must rely on the fiduciary for a particular service.").

155. *See id.* at 795.

156. *See, e.g.*, Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."); Anabtawi & Stout, *supra* note 8, at 1263–64 (explaining this concept of fiduciary law—commonly referred to as the exclusive benefit rule—and its relaxed application in the corporate concept); Jordan, *supra* note 152, at 1013 ("Trustees are subject to strict fiduciary duties of impartiality and accountability which, due to a quirk of medieval history, were enforced by a separate *ecclesiastic* court system known as Courts of Equity." (emphasis in original)).

157. *See* VINTER, *supra* note 150, at 34 ("A trustee is not entitled to remuneration for his services, so a gift to him from a *cestui que trust* is liable to be set aside.").

158. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). An agency relationship is a consensual relationship between the principal and agent and typically involves a third person with whom the agent deals on the principal's behalf. *Id.* § 1.01, cmt. c ("As defined by the common law, the concept of agency posits a consensual relationship in which one person, to one degree or another or respect or another, acts as a representative of or otherwise acts on behalf of another person with power to affect the legal rights and duties of the other person.").

tion and, in most instances, its shareholders.[159] In each of these relationships, the fiduciary has a consensual or statutory obligation to act on behalf, and for the benefit, of a third party.[160]

As courts have expanded fiduciary law, the common traits among designated fiduciaries have become less apparent.[161] Courts rarely focus on the purpose of the relationship between the parties or whether the fiduciary was assuming a trustee-like role.[162] More often, they focus on the potential for abuse in

159. *See id.* § 1.01, cmt. c ("The elements of common-law agency are present in the relationships between employer and employee, corporation and officer, client and lawyer, and partnership and general partner."); *supra* Part II.A.

160. Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1058 (2007) ("[A]gency law, at least in the United States, requires explicitly that an agent act 'loyally for the principal's benefit' in all matters connected with the agency relationship." (quoting RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006))); *see also* DEL. CODE ANN. tit. 8, §§ 141(a), 142 (2001) (stating that the board is responsible for management of the corporation and selection of officers); MODEL BUS. CORP. ACT §§ 8.01(b), 8.40–.41 (2002) (explaining the functions and duties of officers).

161. *See, e.g.*, Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. L. REV. 925, 934–35 (2006) ("[T]he characteristics of even the standard or conventional fiduciary relationships—these include trustee-trust beneficiary, agent-principal, lawyer-client, guardian-ward, director-corporation, and partner-fellow partner and partnership—are too varied to enable one to distill a single essence or property that unifies all in any analytically satisfactory way . . . ." (footnote omitted)); Easterbrook & Fischel, *supra* note 105, at 425 ("During the last two centuries, courts have been adapting [the trustee's] duty of loyalty and its remedy to other agency relations, under the title 'fiduciary' duty. That is adaptation, not extension." (footnote omitted)); Frankel, *supra* note 153, at 805–07; D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1400–01 (2002).

162. *See, e.g.*, Pentech Pharms., Inc. v. Par Pharm., Inc., No. 04-C-3149, 2004 WL 2390088, at *2 (N.D. Ill. Oct. 21, 2004) ("A fiduciary relationship arises between parties only in those circumstances where there exists a relationship that constitutes something more than an arms-length contractual arrangement." (internal quotation marks omitted)); Horejs v. Steele (*In re* Steele), 292 B.R. 422, 428 (Bankr. D. Colo. 2003) ("[T]he language in those cases focus on general duties of fair dealing owed by corporate officers and directors in finding fiduciary duties rather than focusing on specific law which imposes such fiduciary duty."); Waddell v. Dewey County Bank, 471 N.W.2d 591, 593–94 (S.D. 1991) ("[T]he relationship between a bank and its borrower can become a fiduciary relationship only if (1) the borrower reposes faith, confidence, and trust in the bank, (2) the borrower is in a position of inequality, dependence, weakness, or lack of knowledge, and (3) the bank exercises dominion, control, or influence over the borrower's affairs."); Morrison v. Gugle, 755 N.E.2d 404, 412 (Ohio Ct. App. 2001) ("The critical question is not whether one shareholder is a minority and the other a majority, but rather whether one owner so dominated the corporation that he or she can be said to have been in control to the exclusion of the other."); Smith, *supra* note 161, at 1400 ("In ad-

the relationship. As a result, courts frequently use fiduciary law as a means to control one party's conduct where they perceive a potential power imbalance between the parties.[163]

The potential for abuse and self-dealing underlies the designation of controlling stakeholders as fiduciaries.[164] A controlling stakeholder is not a fiduciary in the traditional sense.[165] A shareholder or creditor is not a trustee entrusted to manage or protect the property of third-party beneficiaries. Rather, the shareholder or creditor likely *is* the beneficiary in the relationship.[166] State corporate law identifies the board as the entity entrusted with managing corporate affairs for the benefit of the corporation and its stakeholders.[167]

The roles of shareholders and creditors are converging under the influence of private funds and other institutional investors using their equity and debt positions to achieve their activ-

dition, courts regularly impose fiduciary obligations ad hoc in relationships where one person trusts another and becomes vulnerable to harm as a result.").

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

164. *Cf.* Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1119–20 (Del. 1994).

165. "The person who holds property in trust is the trustee." RESTATEMENT (THIRD) OF TRUSTS § 3 (2003). "A trust [other than a resulting or constructive trust] . . . is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons. . . ." *Id.* § 2. Neither shareholders nor creditors hold property in trust for others. Moreover a constructive or resulting trust typically is a remedy for wrongful conduct. *See id.* § 1, cmt. e. Absent a fiduciary duty, acting in self interest generally is not wrongful conduct. Although early case law referred to controlling shareholders as "trustees," that analogy no longer applies to the commercial relationship between a corporation and its stakeholders. *See* S. Pac. Co. v. Bogert, 250 U.S. 483, 492 (1919) ("It is the fact of control of the common property held and exercised . . . that creates the fiduciary obligation.").

166. *See supra* Part I.

167. *See infra* Part V.A.

ist agendas.[168] Consequently, the relationship between stakeholders and the corporation is gravitating towards a more commercial rather than trust relationship.[169] Stakeholders do not hold positions of trust and confidence with respect to the corporation or other stakeholders.[170] Most stakeholders can buy and sell interests in the corporation (whether securities or debt instruments) in the open market.[171] These transactions and stakeholders' dealings with the corporation generally are based on public information. Consequently, any analogy between corporate stakeholders and traditional trustee-like fiduciaries is superficial and outdated.

Indeed, in the typical corporate context, the shareholder contributes capital to the corporation; the creditor extends credit or loans money to the corporation.[172] Each relies on corporate management, not other stakeholders, to protect its investments and comply with its contracts. The board's duty to act in the corporation's best interests in turn applies whether the board is evaluating a transaction with an unrelated party or an insider.[173] The board's failure to fulfill its duty should not make the other party to the transaction a fiduciary.

Yet this fact pattern describes most controlling stakeholder cases. The board approves a transaction that benefits a control-

168. *See supra* Part III.C.

169. A quid pro quo, or an exchange of an item or good for another of value, often is cited as "the defining characteristic of a commercial transaction." United States v. Bailey, 115 F.3d 1222, 1236 (5th Cir. 1997) (Smith, J., dissenting). Corporations sell and shareholders buy stock; corporations sell and creditors buy bonds; lenders sell and corporations buy financial products. Each of these transactions exhibits characteristics of a commercial transaction. *See, e.g.*, Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 338–39 (2006) (discussing risk inherent in investment contracts and characterizing these contracts, including shareholder contract, as commercial transactions). A "commercial transaction" and a transaction involving "trust and confidence" are not mutually exclusive concepts. Nevertheless, the concept of "trust and confidence" is the traditional focus of a fiduciary transaction.

170. *See, e.g.*, Midwest Decks, Inc. v. Butler & Baretz Acquisitions, Inc., 649 N.E.2d 511, 518 (1995) ("The party asserting a fiduciary relationship must show that it placed its trust and confidence in another who thereby gained dominance over that party.").

171. *See supra* Part III. Both shareholders and creditors also can protect their interests through diversification. *Cf.* Maurice Obstfeld, *Risk-Taking, Global Diversification, and Growth*, 84 AM. ECON. REV. 1310, 1326–27 (1994) (discussing investor diversification and its role in the markets).

172. *See, e.g.*, Velasco, *supra* note 90, at 409–11 (discussing shareholder capital investment in corporations).

173. *See infra* Part V.A.

ling stakeholder to the exclusion of other stakeholders, and the controlling stakeholder's alleged influence over the board's decision is cited as grounds to impose fiduciary duties on the stakeholder.[174] This reasoning ignores the stakeholder's lack of authority to make corporate decisions.[175] In fact, in the controlling-creditor context, the contract may specifically provide that the creditor does not have such authority and is not a fiduciary for the corporation.[176]

Focusing solely on a controlling stakeholder's influence over the board also overlooks basic elements of the board-stakeholder relationship. Shareholders and creditors invest in or transact with a corporation to make a profit.[177] Self-interest motivates these transactions. The law generally recognizes this fact. For example, a shareholder, even a majority shareholder, can vote its shares in a self-interested manner.[178] A creditor has no legal duty to negotiate a contact favorable to the corporation.[179] Stakeholders do not undertake any obligation to act

174. *See supra* Part III.D. Encouraging a fiduciary to breach its duty does not make the third party a fiduciary, but the conduct may subject the third party to aiding and abetting claims. *See* Rosener v. Majestic Mgmt., Inc. (*In re* OODC, LLC), 321 B.R. 128, 144 (Bankr. D. Del. 2005).

175. *See* Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 HOFSTRA L. REV. 175, 207 (2004) ("[T]he basic premise of corporate law [is] that stockholders do not manage the corporation.").

176. *See, e.g.*, Power & Tel. Supply Co. v. SunTrust Banks, Inc., 447 F.3d 923, 928 (6th Cir. 2006) ("The new . . . credit facility, was documented by Restated Credit and Restated Security Agreements, which explicitly provided that nothing in them or any related documents created a fiduciary relationship between P & T [borrower] and either SunTrust or any participating lender.").

177. *See, e.g.*, Barry E. Adler, *Bankruptcy and Risk Allocation,* 77 CORNELL L. REV. 439, 473–76 (1992) (discussing differing incentives among corporate investors); Baird & Rasmussen, *supra* note 78, at 1245 ("Private lenders are not charitable institutions. They will act to maximize their rate of return when they engineer the appointment of a CRO or otherwise exercise their influence."); Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235, 249–50 (2006) (explaining mutual fund motivation in equity investments); Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 55–57 (2005) (discussing investor economic motivations versus ethical motivations); Velasco, *supra* note 90, at 413 ("Shareholders invest in corporations primarily for economic gain.").

178. *See, e.g.*, McMullin v. Beran, 765 A.2d 910, 919 (Del. 2000) ("[T]he majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board's consideration.").

179. For example, creditors may use restrictive covenants in their debt contracts with a corporation to influence management investment decisions in a manner that arguably contradicts shareholders' interests. *See, e.g.*, Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 1028 (1995) ("[I]t is not an objec-

in the best interest of others.[180]

The law could impose this obligation on stakeholders, but the inherent conflict of interest may undermine the effectiveness of the remedy.[181] Stakeholders with a vested interest in a transaction are not in a strong position to evaluate the transaction objectively. Moreover, imposing a fiduciary-like duty on these stakeholders may create a false sense of alliance between the stakeholder's and the board's objectives. The stakeholder and the board should be on opposite sides of the negotiating table. Acknowledging the self-interest of the stakeholder and calling on the board to assess the transaction in light of that self-interest may encourage a more thoughtful analysis by the board.

2. Uncertainty in Identifying Controlling Stakeholders

Courts generally require a plaintiff to show that a stakeholder controlled and dominated corporate affairs in order to impose fiduciary duties on that stakeholder. "'Control' and 'domination' are difficult terms to define precisely, but 'at minimum . . . imply (in actual exercise) a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.'"[182] In the controlling-creditor context, something more than simple control in a commercial lending relationship, e.g., excessive control, is the standard.[183]

Proving control or domination can be a difficult and fact-

tive of management to maximize bondholder wealth. Instead, bondholders, or more specifically, the bond covenants, serve primarily as constraints on managerial behavior." (footnote omitted)); Remus D. Valsan & Moin A. Yahya, *Shareholders, Creditors, and Directors' Fiduciary Duties: A Law and Finance Approach*, 2 VA. L. & BUS. REV. 1, 45 (2007) ("Rational bondholders anticipate shareholders' incentives and, therefore, include restrictive covenants in the bond indentures.").

180. In a market economy, these investors should be free to pursue their own profit-maximizing agendas, even in their negotiations and dealings with the corporation. Nevertheless, they should not be able to achieve their objectives through fraud, misrepresentation, or criminal conduct. For that reason, the fairness proposal would not designate stakeholders as fiduciaries but would subject their conduct to applicable nonfiduciary law. *See infra* note 268.

181. *See infra* Part IV.D.

182. Dennis J. Block et al., *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 BROOK. L. REV. 65, 74–75 (1993) (quoting Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971)) (noting that in the shareholder context, control is shown by majority stock ownership or actual control over board decisions).

183. *See supra* Part IV.B.

intensive proposition. To satisfy her burden, a plaintiff typically must demonstrate "'that the directors are 'beholden' to [the controlling person] or so under their influence that their discretion would be sterilized.'"[184] Courts further presume a director's independence unless the plaintiff establishes that the particular director's interest in a transaction or connection with a controlling shareholder or director impairs her judgment.[185]

A stakeholder's influence over a director and that director's resulting conflict may be subtle and not readily apparent to the outside observer.[186] Board members may serve on other boards with the stakeholder, may do business with the stakeholder in ordinary course matters, may socialize with the stakeholder, or may fear retribution from the stakeholder in the media or in subsequent business matters.[187] Reported case law frequently deals with the easier cases of conflict or lack of independence involving directors designated or paid by the controlling stakeholder or receiving a financial benefit from the controlled transaction.[188]

Nevertheless, even in these easier cases, the outcome is uncertain. A stakeholder's right to appoint directors to the board is not conclusive evidence of control.[189] Likewise, a

184. Orman v. Cullman, 794 A.2d 5, 24 (Del. Ch. 2002) (quoting Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)).

185. *Id.* at 22; *see also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) ("We have generally defined a director as being independent only when the director's decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations.").

186. *See* James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 1008 (noting the common grounds for conflict and lack of independence in the derivative litigation context, such as family and business relations, but "[t]he more subtle malady of structural bias cannot be treated solely by noting suspect relationships and the manner of the directors' appointment"); *infra* note 235.

187. Activist stakeholders often use the media or public filings to try to influence board action. *See, e.g.*, Kahan & Rock, *supra* note 62, at 1029–31 (discussing an activist hedge fund's public criticism of various CEOs); Salton Inc., Amendment No. 2 (Schedule 13D/A), Ex. 1 (Feb. 15, 2005) ("While [the CEO] hobnobs at such social events and is driven around in a chauffeured limousine—I can only assume he has a chauffeur paid for by the Company; how else can one explain the $52,966 annual car allowance disclosed in the Company's proxy statement?—Salton's shareholders and bondholders suffer the consequences.").

188. *See supra* Parts III.C and III.D.

189. *See In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 588 (Del. Ch. 2007) ("[I]t is well-settled that a director's appointment at the behest of a controlling shareholder does not suffice to establish a lack of indepen-

stakeholder's ability to purchase additional shares in the open market to obtain a majority position is not sufficient.[190] A stakeholder's threat of a hostile takeover or termination of a commercial relationship with the corporation, however, may cause the stakeholder to be treated as a fiduciary.[191] This uncertainty reflects, in part, the reality that boards wrestle with potential conflicts of interest and issues of divided loyalty whenever they are asked to pursue a transaction proposed by, benefiting, or involving a particular stakeholder.[192]

D. Expanding Fiduciary Law to Increase Stakeholder Accountability

Courts or policymakers could expand existing fiduciary law to treat activist, as well as controlling, stakeholders as fiduciaries. As noted above, Professors Anabtawi and Stout have endorsed this type of expanded fiduciary duty for activist shareholders.[193] This solution would attempt to curb stakeholders' self-interest in their dealings with the corporation.[194] It also would allow the corporation and injured stakeholders to seek damages directly from the controlling stakeholders.[195] Imposing fiduciary duties on a controlling or activist stakeholder has the appeal of punishing the party perceived to be profiting at the expense of the minority.[196]

dence.").

190. *See, e.g.*, *In re* W. Nat'l Corp. S'holders Litig., No. 15927, 2000 WL 710192, at *6 (Del. Ch. May 22, 2000) ("[T]he fact that American General could acquire a numerical majority stock interest in Western National in the open market is not sufficient to convert its status as a substantial minority shareholder to that of a fiduciary." (emphasis omitted)). *But see In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 552 (Del. Ch. 2003) (considering the votes of the thirty-five-percent shareholder's subordinate and family in making controlling shareholder decision).

191. *See, e.g.*, Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1120 (Del. 1994) (stating threat of hostile takeover may support breach of fiduciary duty claim against the controlling shareholder); Williamson v. Cox Commc'ns, Inc., No. 1663-N, 2006 WL 1586375, at *5 (Del. Ch. June 5, 2006) (deciding commercial relationship between shareholders and corporation may support finding of control).

192. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. Ch. 1993) (making presumption that director is independent only when decision is based on corporate merits and not personal bias).

193. *See* Anabtawi & Stout, *supra* note 8, at 1295 (proposing the extension of controlling shareholder fiduciary duties to activist shareholders).

194. *See id.*

195. *See id.* at 1294.

196. *Cf. id.* at 1294 ("We suggest treating the underlying disease [i.e., shareholder opportunism], rather than merely trying to ameliorate its symp-

Expanding fiduciary law to include activist stakeholders may address the potential for abuse in stakeholder transactions. The success of this approach would depend on several factors, including the risk appetite of the stakeholders, the subtlety of their control or activism, and whether their vision for the corporation was aligned with or viewed as contrary to the wealth-maximizing potential of the corporation.[197] This approach may, however, also increase the uncertainty in controlling stakeholder fiduciary law and suppress, rather than promote, investor confidence.[198]

Stakeholders often look to controlling or activist stakeholders to monitor the board and for signals regarding corporate performance.[199] Stakeholders as monitors can provide valuable information to other stakeholders and the markets generally. Controlling or activist stakeholders have the incentive and resources to perform this monitoring role. Monitoring in turn may reduce the agency costs inherent in the dispersed ownership model.[200]

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toms.").

197. *See supra* Part IV.C.2.

198. *See supra* Part IV.C.2. Certainty promotes effective corporate law. *See In re* Topps Co. S'holders Litig., 924 A.2d 951, 958 (Del. Ch. 2007) (acknowledging value of "efficient and predictable corporation law"). Corporate law in turn can bolster investor confidence. *See* Black, *supra* note 53, at 836–40 (explaining role of investor protections in creating strong securities market); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 4 (2000) ("Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders."); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1166–69 (2002) (explaining role of minority protections in investor confidence and corporate value). An expanded concept of controlling or activist stakeholder as fiduciary further removes this designated corporate fiduciary from the trusteeship origins of fiduciary law. *See supra* Part IV.C.1.

199. *See, e.g.*, *Brinks Could See Sale Soon*, SECINVESTOR, Dec. 18, 2006, http://www.secinvestor.com/2006/12/18/Brinks+Could+See+Sale+Soon.aspx ("The fundamental valuation of the company along with this coalition of activist shareholders bent on unlocking value make BCO a stock worth watching in the next couple of months."); Posting of Chad Brand to Peridot Capitalist, http://www.peridotcapitalist.com/?s=What+does+a+3.5%25+stake+by+ackman's+activist+firm+pershing+square+mean+for+sears (Oct. 5, 2007) ("There are two possible reasons we could be excited about the news that Pershing Square has amassed a $700 million stake in Sears; it represents a new investment by a very smart value investor, and it signals that Ackman plans to take a large activist role with the company and management, leading to changes that will unlock shareholder value.").

200. *See* Black, *supra* note 53, at 833 ("Institutional voice can reduce both shareholder and manager myopia."); *see also* Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 247–48 (2002) (explaining in the context of a

Any proposed solution governing controlled transactions should consider the role of the controlling stakeholder as monitor.[201] The impact of expanding stakeholder fiduciary duty on corporate monitoring is unknown. In light of the controlling stakeholder's self-interest in monitoring, the impact may be nominal. Nevertheless, potential fiduciary duties may deter some activist stakeholders from monitoring or publicly announcing their interests in a corporation.[202]

V. AN ALTERNATIVE TO CONTROLLING-STAKEHOLDER DUTIES

The potential for controlling stakeholders to freeze out the minority, negotiate below-market commercial contracts, and use their positions to purchase corporate assets illustrates the need to strictly scrutinize controlled transactions.[203] The board should provide enhanced oversight to protect corporate investments and promote investor confidence.

A. THE BOARD AS FIDUCIARY

Corporate law designates the board as manager of corporate affairs.[204] The board is entrusted with the corporation's property and is expected to manage that property for the corporation's benefit. Most directors have limited proprietary interests in the corporation, and existing law generally proscribes or sharply limits transactions between a director and the corpora-

study assessing causes and depths of agency costs that controlling shareholders supply "good services to the firm and one powerful bad service: the good ones are monitoring managers, facilitating information flow from inside the firm to capital owners, and making implicit deals with stakeholders when soft deals are efficient; their one big bad activity is their stealing from the minority stockholders" (citations omitted)).

201. *See* Anabtawi & Stout, *supra* note 8, at 1304–06 (acknowledging potential chilling effect of treating activist shareholders as corporate fiduciaries but suggesting that such concern may be overstated and that any resulting restrictions on activism may be warranted).

202. Some commentators suggest that existing restrictions, without imposition of a fiduciary duty, on shareholder monitoring may deter beneficial activism. *See* Illig, *supra* note 47, at 249–53; *see also* Black, *supra* note 60, at 523 (explaining placement of burden on fiduciary while beneficiary derives the benefit).

203. *See* Anabtawi & Stout, *supra* note 8, at 1271–74 (discussing minority freeze-outs).

204. *See* DEL. CODE ANN. tit. 8, §§ 141(a),142 (2001) (making board responsible for management of corporation and selection of officers); MODEL BUS. CORP. ACT §§ 8.01(b), 8.40–.41 (2002) (outlining board member corporate powers and their ability to appoint officers).

tion.[205] The board occupies a position of trust and confidence—a fiduciary position—with respect to the corporation.[206]

The board's fiduciary role places it in a strong position to evaluate and protect the corporation against controlled transactions. The board evaluates proposals from shareholders and contracts with creditors.[207] The board has the resources to assess these transactions and determine the best course for the corporation.[208] The board's evaluation process should consider both the short- and long-term effects of the transaction.

For example, in a shareholder-proposed transaction, the board is well-equipped to assess the transaction.[209] The board, with the assistance of management and professionals, understands the corporation's business and whether the proposed transaction presents a positive net-present-value opportunity for the corporation. It also has the resources to identify the conflicts inherent in the transaction and to factor those conflicts into the transaction's valuation.[210] Likewise, in a financing transaction, the board has the ability, through risk management activities and other measures, to determine and mitigate the impact of the contract provisions being negotiated with lenders and key customers.[211]

In theory, boards are in a better position to protect the corporation against controlled transactions, particularly as boards

205. *See* tit. 8, § 144 (discussing standards for ratification of interested-director transactions); *see also* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (explaining that public policy "has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty").

206. As discussed above, the board is not a traditional trustee with respect to the corporation. Corporate law has relaxed certain aspects of fiduciary law for directors. See *supra* Part IV.C.1.

207. *See* Velasco, *supra* note 90, at 416; *see also* Thomas A. Russo, *Beyond SOX 404*, 9 STAN. J.L. BUS. & FIN. 281, 290 (2004) (discussing board responsibilities in the context of integrated risk management and corporate governance).

208. *See* Russo, *supra* note 207, at 290.

209. *See* Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1170 (2005) (noting board independence requirements, their usefulness, and why this situation prepares the board).

210. *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 248 (2008).

211. *See id.* at 249 (explaining uses of financial risk management and noting that "[a] key feature of the claim that risk management increases firm value is its ability to reduce cash flow volatility"); *see also* Russo, *supra* note 207, at 290–93 (discussing board resources and responsibilities).

increase the number of independent board members.[212] A controlling or interested stakeholder necessarily will view the proposed transaction from its favored vantage point.[213] Mandating, through fiduciary duty law, that the controlling stakeholder do otherwise may dress up, but likely will not change, the outcome. Thus, the board itself should be more objective in its assessment of the transaction.[214]

In practice, however, boards appear unable or unwilling to make the difficult decisions necessary to protect the corporation.[215] A board must have the fortitude to stand up to the controlling stakeholder to fulfill its fiduciary role in the controlled transaction context. Saying no to shareholders or creditors who either control the directors' reelection to the board or the corporation's cash flow is not easy.[216] Ideally the law should provide the board with both incentives to scrutinize these transactions carefully and leverage to fend off controlling stakeholders.[217]

B. THE BOARD'S ROLE IN CONTROLLED TRANSACTIONS

Several factors may explain board passivity in controlled transactions.[218] Loyalty to the controlling stakeholder, self-

212. *See* Seligman, *supra* note 209, at 1170 (explaining board independence requirements under the Sarbanes-Oxley Act and NYSE and NASDAQ listing requirements).

213. *See* Cox, *supra* note 186, at 1008 (noting potential for conflict and lack of independence).

214. *See id.*

215. *See* Deborah A. DeMott, *The Mechanisms of Control*, 13 CONN. J. INT'L L. 233, 247–51 (1999) (surveying controlling shareholder cases involving breaches of loyalty by board); Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 760–65 (2008) (explaining board neutrality in controlled creditor transactions).

216. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) ("[T]he controlling shareholder will continue to dominate the company regardless of the outcome of the transaction. The risk is thus created that those who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation by the controlling shareholder." (citation omitted)).

217. *See* Cox, *supra* note 186, at 962 (discussing potential sources for biased judgment in the current model); DeMott, *supra* note 215, at 251 ("The fact that the corporation has a majority shareholder does not relieve directors of their fiduciary duties of care and loyalty; domination is not a defense to claims arising from the breach of duties owed to minority shareholders or, for that matter, to nonshareholder third parties.").

218. In a prior article, I refer to this development in the corporate restructuring context as "management neutrality." Harner, *supra* note 215, at 760–63. Regardless of the financial condition of the corporation, the concept suggests a shift in management responsibilities from the board to the controlling

preservation, shareholder bias, a perceived lack of leverage, and perhaps general apathy all may contribute to the problem.[219] In addition, the limited judicial oversight applicable to most board decisions must be considered. The protection afforded to boards by the business judgment rule may foster and shield board passivity even in the context of conflicts of interest.[220]

The business judgment rule is a presumption that board decisions are made in good faith, on an informed basis, and in the best interests of the corporation.[221] A plaintiff challenging a board's decision may rebut the presumption by showing gross negligence, waste, self-dealing, fraud, or other similar conduct by the board.[222] If the presumption is rebutted, the board bears the burden of establishing that the decision was fair to the corporation.[223]

The business judgment rule plays an important role in limiting judicial intervention in corporate affairs, thereby preserving the independent management role of the board. "Under this familiar rule of American jurisprudence, the courts refrain from second guessing business decisions made by corporate directors in the absence of a showing of fraud, unfairness or overreaching."[224] Management, as the business experts, should have discretion with respect to routine business matters and

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stakeholder. *Id.*

219. *See* Cox, *supra* note 186, at 962.

220. *See infra* notes 225–28. In general, courts do not review the substance of board decisions protected by the business judgment rule. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("As for the plaintiffs' contention that the directors failed to exercise 'substantive due care,' we should note that such a concept is foreign to the business judgment rule.").

221. *See* Stanziale v. Nachtomi (*In re* Tower Air, Inc.), 416 F.3d 229, 238 (3d Cir. 2005); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* MODEL BUS. CORP. ACT § 8.30(a) (2002) ("Each member of the board of directors . . . shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation."). Commentators have not definitively settled whether the business judgment rule extends to decisions by senior management. *See* Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005) ("[T]he topic remains relatively unexplored."); *see also* Bank of Am. v. Musselman, 222 F. Supp. 2d 792, 797 n.10 (E.D. Va. 2002) (surveying cases applying different standards). For purposes of this Article, I treat directors and senior management in a similar manner with respect to fiduciary duties and judicial review.

222. *See In re Walt Disney*, 906 A.2d at 52.

223. *Id.*

224. Capital Bancshares, Inc. v. FDIC, 957 F.2d 203, 207 (5th Cir. 1992).

transactions between the corporation and unrelated third parties. The business judgment rule may be counterproductive, however, in the controlling stakeholder context discussed here.

Under existing law, board approval of a controlled transaction may be subject to review under the business judgment standard.[225] The lower standard of review is applicable when the transaction involves a shareholder, but the plaintiff is not able to show that the shareholder controlled or dominated a majority of the board.[226] As discussed above, a plaintiff may encounter significant hurdles in proving the requisite control or domination.[227]

If actual control or domination is shown, the controlled transaction is subject to review under the entire-fairness standard.[228] The heightened burden imposed on the controlling shareholder and any interested directors may nonetheless be eased if the transaction is approved by a fully informed majori-

225. *See* Block et al., *supra* note 182, at 72–75 (explaining requirements for invoking heightened scrutiny of controlled transactions and noting that, absent a showing of majority ownership or actual control, the challenged transaction may be reviewed under the business judgment rule); *see also In re* W. Nat'l Corp. S'holders Litig., No. 15927, 2000 WL 710192, at *26 (Del. Ch. May 22, 2000) ("Delaware law will not attach liability to decisions of independent, disinterested and informed directors."). In addition, if the plaintiff does not allege sufficient facts to invoke the duty of loyalty, the directors may be protected by an exculpatory clause in the corporation's articles of incorporation. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (explaining articles of incorporation may include "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director").

226. *See, e.g.*, *In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 550 (Del. Ch. 2003) ("If the defendants can convince the court that the large blockholder is not a controlling stockholder, then the presence of an independent board majority will invoke the business judgment rule standard of review, leading to probable victory for the defendants without the need for trial." (citation omitted)); *In re W. Nat'l Corp.*, 2000 WL 710192, at *26 ("The policy rationale requiring some variant of entire fairness review . . . substantially, if not entirely, abates if the transaction in question involves a large though not controlling shareholder."); *id.* (invoking business-judgment review because "[t]he facts of this case . . . hold out little if any prospect for retaliation against the Company's public shareholders").

227. *See* Orman v. Cullman, 794 A.2d 5, 24 (Del. Ch. 2002) (discussing the extensive burden that plaintiff must overcome).

228. *See* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) ("Ordinarily, in a challenged transaction involving self-dealing by a controlling shareholder the substantive legal standard is that of entire fairness, with the burden of persuasion resting upon the defendants."); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (implementing intrinsic-fairness test); *In re* Wheelabrator Tech. Inc. S'holders Litig., 663 A.2d 1194, 1204 (Del. Ch. 1995) (explaining the standard of review for duty of loyalty cases).

ty of disinterested directors or shareholders. Approval by disinterested directors or shareholders generally shifts the burden of proof to the plaintiff to show that the transaction was unfair to the corporation.[229]

In light of the benefits derived from disinterested director approval, boards routinely appoint "special committees" of disinterested directors to review and approve controlled transactions.[230] Some courts have endorsed this practice as a means to cleanse interested director or shareholder transactions.[231] As a result, the plaintiff bears the burden of proof in most controlled transaction litigation.

C. INCREASING BOARD ACCOUNTABILITY IN STAKEHOLDER TRANSACTIONS

The board's accountability in controlled transactions is uncertain and often based on the allegations set forth in the complaint, and the forum in which the complaint is filed.[232] The fairness proposal seeks to increase certainty in the law governing stakeholder transactions. It identifies a single fiduciary and provides a uniform standard of review. It also attempts to strike an appropriate balance between the rights of individual investors and those of the corporation and its stakeholders generally. Accordingly, the proposal encourages the board on the one hand, and stakeholders on the other, to fill the roles for which they are best suited—the board acting as corporate decisionmaker and stakeholders acting as corporate monitors.

229. *See Kahn*, 694 A.2d at 428 ("The burden [to satisfy the entire fairness standard] . . . may be shifted from the defendants to the plaintiff through the use of a well functioning committee of independent directors."); *see also* DEL. CODE ANN. tit. 8, § 144 (2001) (providing that an interested-director transaction is not necessarily void or voidable if approved by a majority of disinterested directors or shareholders).

230. *See* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1349–50 (2005) (discussing use of special committees by boards in the litigation context and various standards of review invoked by courts in response to committee recommendations).

231. *See, e.g., Kahn*, 694 A.2d at 428 (discussing special committee decisions and the accompanying burden of proof); Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983) ("Although perfection is not possible, or expected, the result here could have been entirely different if [the board] . . . had appointed an independent negotiating committee of its outside directors to deal with [the shareholder] . . . at arm's length.").

232. *See supra* Part V.B.

1. Key Elements of the Fairness Proposal

The fairness proposal would include and govern transactions with not only majority shareholders and those parties traditionally characterized as controlling shareholders or creditors, but also activist stakeholders. A stakeholder transaction would include any out-of-the-ordinary business transaction with, or supported by, an existing stakeholder that benefits such stakeholder at the expense of the corporation.[233] Representative transactions might include asset acquisitions and dispositions, debt refinancing transactions, mergers, recapitalizations, and share repurchases.[234]

The fairness proposal would presume a conflict of interest with respect to the entire board.[235] This presumption would not

233. Neither unequal treatment nor *pro rata* distributions alone would qualify a transaction as a stakeholder transaction subject to increased scrutiny. *See* Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 75–78 (1999) (discussing the threshold issue of whether the corporation is injured in controlled transactions).

234. The concept of stakeholder transactions focuses on out-of-the-ordinary-course contracts between a stakeholder and the corporation (e.g., refinancing agreements and certain asset or stock purchase agreements); mergers or acquisitions in which a stakeholder holds interests in both the target and acquiring corporations; targeted share repurchase agreements; and similar transactions. Ordinary-course business matters generally include "any matter which transpires as a matter of daily custom in business." Medigroup, Inc. v. Schildknecht, 463 F.2d 525, 529 (7th Cir. 1972) (approving jury instruction defining ordinary course of business as "that course of conduct that reasonable prudent men would use in conducting business affairs as they may occur from day to day"); Eagle-Picher Indus v. Caradon Doors & Windows, Inc. (*In re* Eagle-Picher Indus.), 278 B.R. 437, 451 (Bankr. S.D. Ohio 2002). Notably, a change of control transaction might invoke heightened scrutiny under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and its progeny. *See* Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 242 (Del. 2009) (explaining when *Revlon* duties are imposed); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1390 (Del. 1995) (applying heightened scrutiny with respect to board defensive measures); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985) (same). Whether such transactions should be subject to the fairness proposal rather than existing standards is beyond the scope of this Article. Nevertheless, the fairness proposal would be a workable framework for those types of transactions as well.

235. The presumption of conflict would prevent the board from using a special committee of "disinterested" directors to approve the transaction. Even where directors lack a direct personal or financial interest in the transaction, structural bias may impair their analysis. *See* Regina F. Burch, *The Myth of the Unbiased Director*, 41 AKRON L. REV. 509, 544–49 (discussing a recent Yale empirical study supporting "the notion that cognitive bias impacts board decision making in a way that may harm shareholders" and suggesting that this cognitive bias may lead to boards "systematically underestimating the risks of conflict transactions"); Cox, *supra* note 186, at 962, 1008 (explaining the nature of structural bias on corporate boards and recommending that, in

automatically subject the board to challenge on every stakeholder transaction. Rather, the proposal incorporates safeguards to target only those transactions that favor the interests of a particular stakeholder and in turn impair corporate value. In addition, the proposal would impose a relatively short statute of limitations for challenging any stakeholder transaction.[236]

A plaintiff challenging a stakeholder transaction would need to establish her standing to bring the lawsuit, as well as the elements of her prima facie case.[237] To meet the latter, the plaintiff would need to show that the transaction: (a) was not in the ordinary course of the corporation's business; (b) involved an existing shareholder, creditor, or other stakeholder or group of existing stakeholders; (c) provided a unique benefit to those stakeholders; and (d) thereby caused relative economic injury to the corporation or minority holders.[238] To meet the third

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the special litigation committee context, "[t]he most effective remedy for structural bias is to require courts to take a more active role in their review of the directors' recommendation").

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

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

238. A plaintiff would be required to establish corporate damage as part of her prima facie case before the burden of proof would shift to the board to show that the stakeholder transaction was fair to the corporation. The plead-

element of a stakeholder transaction, a plaintiff would need to produce some evidence that the stakeholder received a benefit different from or in addition to that received by other shareholders or, if the stakeholder is a creditor, a benefit different from or in addition to its existing contract rights. A transaction between a corporation and one of its stakeholders, without more, would not be sufficient to support the plaintiff's claim.

If the plaintiff made the required showing, the board then would bear the burden of proof to show that the stakeholder transaction was fair to the corporation.[239] The entire-fairness standard of review generally requires the board to show fair dealing and fair price with respect to the challenged transaction.[240] Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the direc-

ing standard would be similar to that required for a plaintiff to rebut the business judgment presumption. *See, e.g.*, *In re* Gen. Motors Class E Stock Buyout Sec. Litig., 694 F. Supp. 1119, 1132 (D. Del. 1988) ("[I]n order to overcome the presumption of the business judgment rule [the] plaintiff[] must allege with particularity facts which establish that the contested decision was not a product of valid business judgment.").

239. A plaintiff's ability to allege facts and produce some evidence of economic injury to the corporation to sustain her prima facie case would not necessarily lead to the avoidance of the transaction. The board may still be able to show by a preponderance of the evidence that the transaction was fair to the corporation. *Cf.* Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997) (describing a situation where the burden can shift back to the plaintiff). For example, in the context of an asset sale, the board may have data, including projections and business forecasts, or expert valuations that establish the fairness of the transaction despite the plaintiff's allegations of damage.

240. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (describing the entire-fairness test); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (requiring the company to show a transaction was "objectively fair"). The entire-fairness standard should apply to boards' decisions on stakeholder transactions in bankruptcy as well. For example, under existing law, if a debtor corporation wants to sell its assets to an existing stakeholder, bankruptcy courts generally review this type of transaction under the business judgment rule. *See* United States *ex rel.* Rahman v. Oncology Assoc., 269 B.R. 139, 161 (Bankr. D. Md. 2001). Likewise, if the debtor corporation proposes a post-bankruptcy financing facility, commonly referred to as a debtor-in-possession financing facility, with its prebankruptcy lenders, the court should review this transaction under the entire-fairness, and not the business judgment, standard. *See* 7 COLLIER ON BANKRUPTCY ¶ 1108.07[2] (Alan N. Resnick & Henry J. Sommer eds., 15th rev. ed. 2008) (explaining that courts prefer to "weigh the merits of a transaction"). This increased judicial scrutiny of stakeholder transactions in bankruptcy would better protect the bankruptcy estate. *See* Harner, *supra* note 80, at 98–100, 104, 106 (discussing the potential abuse of stakeholder transactions in bankruptcy, the limitations on existing judicial review and the proposal of an estate representative).

tors and the stockholders were obtained."[241] Fair price "relates to the economic and financial considerations of" the challenged transaction.[242]

The board could shift the burden of proof to the plaintiff by showing that the board exposed the stakeholder transaction to a meaningful market test prior to approving the transaction. In this context, "market test" does not necessarily mean putting the company in play or undertaking an auction-like process.[243] Rather, the board could satisfy this test by presenting reliable evidence that it considered reasonable alternatives to, and adequately tested the value of, the proposed transaction.[244] The fairness proposal seeks to protect the interests of the corporation in its dealings with existing stakeholders, a situation where subtle influence and self-interest may impact value. Exposing a stakeholder transaction to competitive pricing and market alternatives furthers that objective and should result in some protection for the board's decision.

2. Consequences Under the Fairness Proposal

The consequences of any given stakeholder transaction litigation would turn largely on the underlying facts. For exam-

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241. *Weinberger*, 457 A.2d at 711.

242. *Id.*

243. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (dealing with the sale of corporate control). In this context, it is broader and more flexible than the market test incorporated into section 5.15(b) of the American Law Institute's Principles of Corporate Governance. *See* 1 AM. LAW. INST., *supra* note 119, § 5.15(b). Moreover, the market test component of the fairness proposal allows the board to ease its burden; it is not an independent obligation.

244. *See* 2 MCCORMICK ON EVIDENCE § 339, at 422 (John W. Strong ed., 5th ed. 1999) ("The most acceptable meaning to be given to the expression, proof by a preponderance, seems to be proof which leads the jury to find that the existence of the contested fact is more probable than its nonexistence."); *see also* Barkan v. Amsted Indus. Inc., 567 A.2d 1279, 1287 (Del. 1989) ("When . . . directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market."). The two key elements of the market test discussed here are (i) exploring reasonable alternatives to the stakeholder transaction, *see* 1 AM. LAW INST. *supra* note 119, § 5.15 cmt. c(1) (stating that an adequate market test will protect against non-arms length transactions), which would include rejecting the transaction and maintaining the status quo, and (ii) using a competitive process or other market mechanism to test the adequacy of the price, *see Barkan*, 567 A.2d at 1288 (explaining that failure to engage in a market survey without a reasonable basis raises a presumption that the board "seeks to forestall competing bids"). Notably, some stakeholder transactions may not lend themselves to a market test; the board would need to meet the traditional entire-fairness test with respect to those transactions.

ple, if a plaintiff lacks standing to bring a derivative action or fails to establish a unique benefit to the involved stakeholder or economic injury to the corporation, the litigation most likely would be dismissed. If the action survives a motion to dismiss and the defendants present sufficient evidence of a meaningful market test, the action may be resolved in the defendants' favor at the summary judgment stage or, if it proceeds to trial, the burden of proof would shift to the plaintiff to establish that the transaction was unfair to the corporation.[245]

If the board does not subject the stakeholder transaction to a market test, then the board would continue to bear the burden of proof to show that the transaction satisfies the entire-fairness test.[246] If the stakeholder transaction is determined to be fair to the corporation, the directors would not face liability and the transaction would not be subject to avoidance. If the directors could not satisfy the entire-fairness test, the directors would face liability for breaches of their duty of loyalty and the transaction would be subject to avoidance.[247]

The fairness proposal also may affect adversely the stakeholders involved in the transaction. If the transaction is avoided, the interested stakeholders lose any benefit from and any investments in the transaction.[248] In addition, if the stake-

245. *See supra* Part V.C. (trying to strike a balance between the rights of investors and the rights of the corporation). Because the fairness proposal presumes that a conflict of interest or potential undue influence exists in stakeholder transactions, the standard remains entire fairness even after the burden of proof shifts to the plaintiff. For similar reasons, approval of the transaction by apparently disinterested directors would not provide a safe harbor for the transaction.

246. A board's failure to subject a stakeholder transaction to a market test does not necessarily render the transaction unfair. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995) ("A finding of perfection is not a *sine qua non* in an entire fairness analysis. . . . Rather, it is a standard by which the Court of Chancery must carefully analyze the factual circumstances, apply a disciplined balancing test to its findings, and articulate the bases upon which it decides the ultimate question of entire fairness.").

247. *See* Cede & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993) ("[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.").

248. *See* Thomas v. Brownville, Fort Kearny & Pac. R.R. Co., 109 U.S. 522, 524 (1883) (voiding interested-director transaction and explaining, "[t]he original contract being such that the contractors can maintain no suit on it, the bonds which they received are affected with the same vice, and cannot be enforced unless they are negotiable instruments in the hands of innocent holders for value"); Todd v. Southland Broad. Co., 231 F.2d 225, 232 (5th Cir. 1956)

holder is a director or has an employee serving as a representative director on the board, the stakeholder may be liable for breaching the duty of loyalty either directly or indirectly under indemnification obligations or an aiding-and-abetting theory.[249] Accordingly, the fairness proposal provides a board with some leverage in its negotiations with an interested stakeholder.

3. Advantages of the Fairness Proposal

The fairness proposal primarily targets significant transactions between a corporation and one or more of its existing shareholders or creditors. It acknowledges that existing stakeholders may have interests in those transactions that do not necessarily align with the best interests of the corporation.[250] It also recognizes that proving a stakeholder's control, domination, or even influence over the board's decision in any given transaction is difficult. Accordingly, the fairness proposal does not require such proof, but presumes the existence of some influence if the transaction provides a benefit to the stakeholder different from its existing entitlements.[251]

("'[When] the proof showed that the action of the board of directors was not binding upon the corporation, the plaintiff was entitled to recover from Martin the money which had been paid to him under that invalid order, unless Martin could show himself entitled to retain it by reason of the fact that he had performed valuable services to the corporation for which he would be entitled to just compensation.'" (quoting Greathouse v. Martin, 94 S.W. 322, 324 (Tex. 1906))); Sunrise Island Ltd. v. Goldman Sachs & Co. *ex rel.* Ballard (*In re* Sunrise Island), 203 B.R. 171, 175–76 (Bankr. N.D. Okla. 1996) (voiding a loan and accompanying collateral package as an interested-director transaction); Cahall v. Lofland, 114 A. 224, 232 (Del. Ch. 1921) ("Special contracts to pay compensation to directors for extra services are everywhere and always voidable if carried by votes of interested directors. Therefore, even if the services rendered by the directors were extraordinary and outside their duties as directors, still they could not have recovered pay therefor in an action . . . ." (citations omitted)).

249. Rosener v. Majestic Mgmt., Inc. (*In re* OODC, LLC), 321 B.R. 128, 144 (Bankr. D. Del. 2005). A claim for aiding and abetting a breach of fiduciary duty generally requires a showing "a) that the fiduciary's conduct was wrongful; b) that the defendant had knowledge that the fiduciary's wrongful conduct was occurring; and c) that the defendant's conduct gave substantial assistance or encouragement to the fiduciary's wrongful conduct." *Id.* (citations omitted). Although a controlling stakeholder's designated representative on the board may be an agent of that stakeholder, courts generally have rejected claims of respondeat superior in the breach of fiduciary duty context. *See* Global Crossing Estate Representative v. Winnick, No. 04 Civ. 2558 (GEL), 2006 WL 2212776, at *20–21 (S.D.N.Y. Aug. 3, 2006) (explaining the rejection of a respondeat superior theory under New York and Delaware fiduciary duty law).

250. *See supra* Part II.D.

251. *See supra* note 235 and accompanying text.

The fairness proposal also encourages disclosure and a more thorough ex ante review of stakeholder transactions. For example, the fairness proposal bases the statute of limitations on the date of disclosure of the transaction to stakeholders generally.[252] In addition, a board may ease its burden and significantly bolster its case by fully informing itself of the transaction's market value and exploring alternatives for the corporation, which could include rejecting the transaction and maintaining the status quo.[253] Although boards should undertake this type of thoughtful review in all instances, the fairness proposal provides incentives to encourage this review in stakeholder transactions where outside influences may otherwise impair the board's judgment and negatively impact corporate value.

VI. POTENTIAL CONCERNS WITH THE FAIRNESS PROPOSAL

The fairness proposal is not a perfect solution to the potential for abuse inherent in controlled transactions. The proposal nonetheless attempts to strike an appropriate balance between protecting corporate interests and preserving the economic rights of individual stakeholders. Proponents of shareholders rights, critics of activist stakeholders, and those concerned with increasing board liability each might propose a different mechanism for addressing controlled transactions. The fairness proposal considers and tries to account for each of these competing interests.[254]

A. SHAREHOLDERS SHOULD HAVE MORE CONTROL

Some commentators argue that shareholders should possess more rights with respect to, and control over, the corpora-

252. *See id.*

253. *See supra* note 244.

254. In addition, the courts' traditional protection of board decisions under the business judgment rule must again be acknowledged. *See supra* notes 226–28 and accompanying text. Nevertheless, in the limited context of stakeholder transactions—where subtle conflict of interest and loyalty issues may exist—courts may be willing to consider increased scrutiny. *See, e.g.*, Gantler v. Stephens, 965 A.2d 695, 708 (Del. 2009) ("[A] cognizable claim of disloyalty rebuts the business judgment proposal."). Courts should consider the value of a bright-line standard in stakeholder transactions given the subtleties involved, the minor impositions placed on the board under this standard, and the resulting protection for the corporation and all of its stakeholders.

tion.[255] This position views shareholders as holding true proprietary, and not merely economic, interests in the corporation. It seeks to bolster the proposition that the corporation should be managed for the sole benefit of shareholders.[256]

Commentators posit different theories of basic corporate governance issues, including whether shareholders are the residual owners of the corporation and whether the corporation should be managed exclusively for the benefit of shareholders.[257] The fairness proposal does not rely upon one particular theory. Regardless of how a shareholder's interest in the corporation is characterized, the shareholder should have the ability to pursue value-enhancing transactions for that interest and should not be required to sacrifice its self-interest for other shareholders.[258]

Unfettered shareholder control in the controlled transaction context, however, would undermine investor confidence and potentially undervalue corporate assets.[259] The board is best equipped to filter proposed controlled transactions and assess their impact on corporate value. If noncontrolling stakeholders believe that the board is incapable of performing this function, they can challenge the transaction and, under the fairness proposal, the court would determine the fairness of the transaction to the corporation.[260] Stakeholders can protect their interests by monitoring the board; the board can protect corpo-

255. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 678 (2007) (suggesting corporate reforms to increase shareholders' rights, including their power to remove directors).

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

257. *See supra* note 110.

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

259. *See* John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1714 (2002) ("Stronger legal protection for minority shareholders is associated with a larger number of listed companies, more valuable stock markets, lower private benefits of control, and a lower concentration of ownership and control."); Stout, *supra* note 110, at 801–02 (observing that investors gravitate to board governance models, as opposed to those that give shareholders more control).

260. *See supra* Part V.C.1.

rate interests by monitoring controlling stakeholders; and the courts can ensure that challenged transactions are fair to the corporation.[261]

B. Controlling Stakeholders Should Have Less Control

Activist stakeholders often are characterized as "vulture" investors who seek to siphon value out of corporations in a relatively short timeframe, without regard to the long-term prospects of the corporation.[262] This characterization aptly describes some activist investors, and commentators are right to question their motives and raise concerns about their impact on corporate value. Not all activist stakeholders, however, fall into this category and many have illustrated an ability to appreciate longer-term objectives of the corporation and to serve as effective corporate monitors.[263]

Imposing fiduciary duties on all controlling or activist investors may or may not curb their self-interest. Many activist investors already factor fiduciary duty into their strategies and seek board appointments for themselves or their representatives.[264] Those activist stakeholders may rationalize that their interests align with any imposed fiduciary duties, pursuing transactions that enhance the value of their holdings and, from their vantage point, overall corporate value.[265] The corporation and other stakeholders may view the transaction differently, and the transaction may in fact be value destructive. Control-

261. This system of checks and balances often is advanced to support increased stakeholder activism. *See* Black, *supra* note 53, at 817 (explaining benefits of institutional investors monitoring management and management monitoring investors in the context of removing barriers to institutional investor activism). The fairness proposal invokes this system with the backstop of judicial review of the fairness of any controlled transaction. *See supra* Part V.C.1.

262. *See Rich Pickings*, *supra* note 27, at 20 ("Vultures are basically value investors, trying to buy an asset for a price well below its intrinsic or fair value.").

263. *See* Bratton, *supra* note 62, at 1410–22 (describing a market study and suggesting that some private funds may generate value at their corporate targets); *see also* Brav et al., *supra* note 75, at 1773 (concluding that stakeholder monitoring can have beneficial effects and add value on average); Hotchkiss & Mooradian, *supra* note 68, at 404 ("[V]ultures' poor public image is not justified with empirical evidence.").

264. *See, e.g.*, Briggs, *supra* note 69, at 718–21 (discussing hedge fund representation on boards).

265. *See id.* at 721 ("[Funds] therefore presumably believe that they will make more money with board representation, even minority representation, than without.").

ling or activist stakeholders are not objective participants in stakeholder transactions and suggesting that the law can make them objective is a fallacy.[266]

The fairness proposal recognizes this fallacy and, accordingly, contemplates pure economic consequences for the controlling stakeholder, including potential avoidance of the transaction and indirect liability for any representative director's breach of her duty of loyalty.[267] These economic consequences, which are similar to those that would be imposed if the stakeholder itself was treated as a fiduciary, may help deter abuse and provide the board with leverage in the negotiation of any stakeholder transaction. The controlling stakeholders also would continue to be subject to nonfiduciary law, including fraud, misrepresentation, equitable subordination, and fraudulent conveyance law.[268]

C. INDEPENDENT DIRECTORS SHOULD NOT FACE INCREASED LIABILITY

Any corporate governance proposal that increases board liability potentially could deter qualified individuals from serving on boards.[269] The deterrent effect is of particular concern

266. *See id.* at 717–18 (stating that fund representatives often discuss information gained as a board member with the fund).

267. *See supra* note 249 and accompanying text.

268. *See supra* Part III.D; *see also* Liafail, Inc. v. Learning 2000 Inc., No. C.A. 01-599 GMS, 2002 WL 31667861, at *4, *6 (D. Del. Nov. 25, 2002) (explaining the elements of fraud in the inducement and negligent misrepresentation claims); *In re* Radnor Holdings Corp., 353 B.R. 820, 839–46 (Bankr. D. Del. 2006) (explaining and evaluating potential claims against a controlling stakeholder); Hauspie v. Stonington Partners, Inc., 945 A.2d 584, 586 (Del. 2008) (explaining elements of common law fraud claim). Although similarities exist between the fairness proposal and fraudulent conveyance law in the distressed-company context, significant differences illustrate the unique value of the fairness proposal. For example, the fairness proposal contemplates a more comprehensive review of a broader range of transactions, and considers not only fair value but also whether the board employed a fair process in considering the transaction. *See supra* Part V.C.1. It also seeks to protect corporate value on an ex ante rather than ex post basis. In addition, the fairness proposal does not depend on a corporation's financial condition. *See supra* note 218 and accompanying text.

269. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059 (2006) (positing that fear of liability may cause qualified people to avoid serving on boards); Burch, *supra* note 235, at 550–51 (discussing the concern of increased director liability and retaining qualified individuals to serve as directors in the context of increased judicial scrutiny of directors' decisions); A. Mechele Dickerson, *Words that Wound: Defining, Discussing, and Defeating Bankruptcy "Corruption,"* 54 BUFF. L. REV. 365, 398 (2006) (discuss-

where the goal of the proposal is to improve corporate management. Qualified individuals are essential to good management. Yet enhanced board responsibilities often are necessary to foster that same goal. This tension can lead to "carrot" or "stick" proposals to encourage good corporate governance.[270]

The fairness proposal suggests the use of sticks to enhance board review of, and better protect corporations from abuse in, controlled transactions.[271] The proposal places the burden of proof to establish the fairness of any stakeholder transaction on the board. Failure to meet this burden would subject the board to liability for a breach of the duty of loyalty. Studies show that independent directors face an increased potential for paying out-of-pocket damages in controlled transaction and breach of the duty of loyalty cases.[272]

The board's potential exposure to real liability in controlled transactions under the fairness proposal may have the desired effect of reducing board passivity and curbing abuse in controlled transactions. This same threat of exposure, however, may cause qualified individuals to decline board appointments.[273] Although the proposal may deter some board candidates, the benefits of board service likely would outweigh any increased risk for most candidates.[274] Moreover, the board

ing how "draconian" liability proposals would "cause some qualified individuals to refuse to serve on boards").

270. *See* Lynn A. Stout, *On the Proper Motives of Corporate Directors (or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 4–5 (2003).

271. *See supra* Part V.C.1–2; *see also* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 451 (2005) ("[B]ecause alternative measures have proved insufficient to deter director laxity, the corporate governance system must rely on legal sanctions and therefore must bear the cost associated with those sanctions.").

272. *See* Black et al., *supra* note 269, at 1090 ("Our data on trials indicate that the primary area in which outside directors of public companies face duty of loyalty claims is not where they have enriched themselves, but rather where they have favored a controlling shareholder—or sometimes the CEO or other inside manager—over minority shareholders." (citing Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 169 (2004)).

273. Black et al., *supra* note 269, at 1059 ("[B]eyond some level of liability risk, qualified people may decide not to serve as directors . . . .").

274. *See* Burch, *supra* note 235, at 550–51 (discussing fears regarding director service following *Smith v. Van Gorkom* and noting that "although there was a decrease in the number of qualified directors who continued to serve, the decrease was temporary"); Fairfax, *supra* note 271, at 451–53 (discussing similar fears after the Enron scandal and enactment of the Sarbanes-Oxley

could mitigate potential liability under the fairness proposal by taking appropriate steps, including requiring full disclosure of potential conflicts, exploring reasonably available alternatives to the controlled transaction, consulting with experts and professionals regarding the proposed transaction, and disclosing the transaction in a timely manner.[275]

D. THE RISK OF INCREASED LITIGATION

An argument could be made that stripping the board of business judgment protection in controlled transactions will open the litigation floodgates. Placing the burden to show the fairness of the transaction on the board may make it more difficult for the board to succeed on a motion to dismiss the litigation.[276] As suggested above, however, the real threat of litigation and resulting liability may not be a complete negative.[277] That threat may be what is necessary to encourage boards to be more than passive participants in controlled transactions.

In addition, the fairness proposal contemplates a short statute of limitations and incorporates concepts of unique benefit and economic injury to act as safety valves against strike suits.[278] A stakeholder transaction would exist only if the plaintiff timely alleged specific facts showing a transaction that involved and provided a unique benefit to an existing stakeholder and that injured the corporation.[279] Absent sufficient allegations, the presumption of board conflict would not apply and the business judgment rule would perhaps be available to protect the board's decision.[280]

Act); s*ee also* Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 379 (2004) ("The decision of whether to serve on a corporate board is influenced not only by the potential liability, or costs, of service, but also by potential rewards."). In addition, directors would be entitled to indemnification for expenses incurred in any litigation under most state corporate codes, provided that no finding of liability is made against the directors. *See, e.g.*, DEL. CODE ANN. tit. 8 § 145.

275. *See supra* Part V.C.1; s*ee also* Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 484–90 (2007) (explaining potential actions by board members to mitigate increased liability risks).

276. *See* Pritchard, *supra* note 127, at 89 ("[A]pplication of the entire fairness standard, even if the controlling shareholder was likely to eventually prevail, 'normally will preclude dismissal of a complaint on a Rule 12(b)(6) motion to dismiss.'" (quoting Orman v. Cullman, 794 A.2d 5, 20 n.36 (Del. Ch. 2002)).

277. *See supra* Part V.C.3, VI.C.

278. *See supra* Part V.C.1.

279. *See supra* Part V.C.1.

280. Likewise, if a stakeholder transaction does not exist, the plaintiff

CONCLUSION

Transactions between a corporation and one or more of its stakeholders are not a new phenomenon. Likewise, the potential for abuse in these transactions is a time-tested truth. The law historically has governed these transactions by treating controlling stakeholders as fiduciaries in their dealings with the corporation. Nevertheless, the fiduciary label does not accurately describe the relationship between stakeholders and the corporation, and the increasing control exerted by activist stakeholders further strains this analogy.[281]

A corporation's stakeholders, whether shareholders, lenders, bondholders, or customers, often possess similar rights with respect to the corporation and invoke these rights to protect or enhance their corporate investment and contract rights.[282] These stakeholders generally do not purchase the stock or the debt of the corporation to benefit the corporation or other stakeholders; self-interest is inherent in all aspects of their dealings with the corporation. Consequently, imposing fiduciary duties on, and demanding undivided loyalty from, these stakeholders is an unsatisfactory solution in most cases.

On the other hand, the board owes an undivided duty of loyalty to the corporation and is better suited to protect the corporation's interest in controlled transactions.[283] The board's vantage point and resources allow it to identify potential stakeholder self-dealing and more objectively evaluate the corporation's alternatives. Yet as business relations become more complex and stakeholders develop new and innovative ways to influence corporate affairs, the board may cede power to the interested stakeholder to the corporation's detriment. Moreover, the board's decision may be protected by the business judgment rule and the transaction may never receive the close scrutiny it warrants.

Courts and policymakers need to reassess the potential for abuse in controlled transactions, particularly in light of increased activism by hedge funds, private equity firms, and other institutional investors. The dynamics between boards and controlling stakeholders are changing; the law governing con-

would be required to show lack of board disinterestedness or independence or grounds to rebut the business judgment presumption in order to file a derivative lawsuit against the board without demand. *See supra* Part V.C.1.

281. *See supra* Part IV.C.1.

282. *See supra* Part III.

283. *See supra* Part V.

trolled transactions must adapt and encourage meaningful ex ante review of any transaction potentially favoring the interests of certain stakeholders. The fairness proposal provides that structure by requiring boards to more closely monitor and filter controlled transactions, pursuing those that enhance corporate value and rejecting those that do not.

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