

SHAREHOLDER (AND DIRECTOR) FIDUCIARY DUTIES AND SHAREHOLDER ACTIVISM
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Abstract

Recent attention to shareholder activism in the business and academic press has ignored the legal ramifications of that phenomenon. Under current law, shareholders are neither principals nor agents of the corporation, the board of directors, or the other shareholders; those seeking to increase shareholder power must confront this legal reality. Specifically, proposals for increased shareholder power on the one hand and recent investor attempts to gain actual management control on the other must both be considered in light of the shareholders' lack of fiduciary responsibility. Moreover, all directors, including those representing "activist" shareholders, are obligated to exercise independent judgment about the best interests of the corporation and may not delegate their decision-making duty either to an individual activist shareholder or to an electoral majority of shareholders.

A quiet (or at least obscure) corner of corporate law academia continues to debate the "trend" (if it is a trend and not a sudden lumpy apparition) toward imposing fiduciary duties on controlling shareholders.¹ There are a number of people who believe this is not and should not be the law, and I am one of those people. I have tried elsewhere² to counter the arguments in favor of imposing fiduciary duties on controlling shareholders and I will not repeat those

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

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

arguments here. The crux of my argument is that fiduciary duties are owed by those who have power, in the legal, “Hohfeldian,” sense, over other people’s persons or property. In the corporate context, that is directors. Shareholders may have indirect power or influence, but they have no legal power over corporate property, and certainly no legal power over other shareholders’ property. They have power only over their own property (their shares) – a fact the law recognizes by zealously protecting the shareholder’s right to vote³ and to sell his or her shares.⁴

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

³See, e.g., *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 659-660 (Del. Ch. 1988).

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

⁵See, e.g., Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005); Imam Anabtawi, *Some Skepticism about Increasing Shareholder Power* (Aug. 2005), UCLA School of Law, Law-Econ Research Paper No. 05-16, available at <http://ssrn.com/abstract=783044>.

a response to related changes in the market. Both kinds of activism raise questions about fiduciary duties in public corporations that have yet to be addressed.⁶

Most of the discussion of shareholder activism has been informed by practical economic and financial considerations rather than legal ones. Law exists, however, and it will apply to business developments such as shareholder governance proposals and hedge-fund activism. It is therefore necessary to understand the relevant law and to consider recent developments in the context of the current legal environment. To that end, I begin with a brief review of fiduciary law, specifically the fact that fiduciary duties apply only to those who have legal power over another's person or property. In Part II I review the legal relationship between shareholders and boards of directors, which is ordinarily a contractual one without fiduciary duties on either side and is not, as some have suggested, a principal-agent relationship. In Part III I briefly examine how the Enron-era scandals shed further light on the arguments about shareholders fiduciary duties. Finally, in Parts IV and V I discuss current trends in "shareholder activism" and how those trends should be understood in light of the law of fiduciary duties.

I. Introduction to Fiduciary Duties, Again

In order to decide whether some class of persons owes a fiduciary duty, one must first determine what gives rise to fiduciary duties in the first place. Because fiduciary duties arose in the ad hoc common law way, we do not have a clear explanation for their existence. However, it

⁶For commentary addressing some of these issues, see Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?* 60 BUS. LAW. 1 (2004) (raising questions about institutional investor activity generally); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate*

is generally accepted that what makes a fiduciary a fiduciary is her power to make decisions with regard to another person's property or person.⁷ Because of that power, the fiduciary must act in the best interests of the other person. A power creates a fiduciary duty if it enables the fiduciary to make decisions that are legally enforceable and can result in liability for the beneficiary. This is "power" in the traditional Hohfeldian sense, and it correlates to a resulting liability in the beneficiary.⁸

Although the fiduciary has the legal power to bind the beneficiary, the beneficiary sometimes has the legal right to control the fiduciary. That control is an essential feature of the agency relationship, for example.⁹ Other beneficiaries, however, do not have control over their fiduciaries. If a trust beneficiary tells her trustee to "invest in this great new stock I just read about in a chat room", and the trustee refuses, the beneficiary has no legal redress.¹⁰ Similarly,

America, 119 HARV. L. REV. 1759 ____ (2006) (noting the agency problems that exist between investment managers of institutional investors and the investors in the funds).

⁷See *Wal-Mart Stores, Inc., v. AIG Life Ins. Co.*, 901 A.2d 106, 113-114 (Del. 2006); sources cited at Dalley, *supra* note X, at 208 n.183. See also STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 425 (2002) (describing fiduciary duties as method of preventing "expropriation by the contracting party with control over the assets" of the other party); *id.* at 37 (noting that "agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant").

⁸See Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16, 44-47 (1913). Some fiduciaries, such as trustees and corporate directors, might be said to have a *right* to control, which would make them more powerful (in the colloquial sense) and perhaps subject to stricter duties, as discussed below.

⁹See RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958) ("Agency is the fiduciary relationship which results from manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act").

¹⁰A trust beneficiary's remedies are limited to specific enforcement of the trust or claims for breach of trust. See IIIA AUSTIN W. SCOTT & WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 199 (4th ed. 1988). The beneficiary's lack of legal control over the trustee can also be inferred

corporations do not have control over their fiduciaries.¹¹ Some principals, although they are legally empowered to exercise control, are in fact unable to exercise meaningful control over their agents because of a lack of knowledge or skill. Unsophisticated clients of attorneys and stock brokers are often as a practical matter completely at the mercy of their agents. This difference in the degree of actual control that the beneficiary has over the fiduciary might account for differences in the nature of the fiduciary relationship and the strictness of its rules,¹² such as the “no further inquiry” rule in trusts, which absolutely prohibits a trustee from transacting with the trust property even if the transaction would benefit the trust or the beneficiary.¹³ Similarly, until recently trustees had no duty to disclose information, however

from the fact that a beneficiary need not have the capacity to make a contract, *see* 2 AUSTIN W. SCOTT ET AL., SCOTT ON TRUSTS § 12.5 (5th ed. 2006), and that the beneficiary ordinarily has no power to remove a trustee. *See id.* § 11.10.3. *See also* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. g, at 43 (Tentative Draft No. 2, 2001).

¹¹The primary beneficiary of a corporate board’s fiduciary duties is the corporation, *see infra* note X, which of course cannot exercise control because it is not a real person. Thus, a corporate board is not an agent. Rather, its powers are “original and undelegated”. *See People ex rel. Manice v. Powell*, 94 N.E. 634, 637 (N.Y. 1911). *See also infra*, Part II.

¹²It is sometimes said that partnership fiduciary duties are stronger than corporate duties. *See Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 516 (Mass. 1975). I have argued elsewhere that this is not the case. *See Dalley, supra* note X, at 191. However, there might be a justification for stricter partnership duties because partners are fully and personally liable for the acts of their partners, and because each partner is both an agent and a principal, so that one partner (as principal) cannot either legally or practically “control” another (as agent). *See id.* at 187-190. Neither of these is true for closely held corporations, and it is therefore inappropriate to apply partner fiduciary duties to close corporations, whether those duties are stricter or not. *See id.*

¹³*See* John H. Langbein, *Questioning the Trust Duty of Loyalty: Sole Interest or Best Interest?* 114 YALE L.J. 929, 931-932 (2005). Professor Langbein describes a number of reasons why the sole interest rule is outdated and should be abandoned. He does not address the feature of trusts that disempowers the beneficiary from controlling the trustee.

material, to beneficiaries unless the beneficiary inquired,¹⁴ presumably because there was nothing the beneficiary could do with the information. However, the amount of control that a beneficiary has over the fiduciary is not an essential feature of a fiduciary relationship. Only the fiduciary's power to bind the beneficiary is necessary.

To give rise to a fiduciary duty, the fiduciary's power over the beneficiary must be a legal one; that is, it must give rise to legal liability on the part of the beneficiary. Many relationships are characterized by one person's ability to affect the life and behavior of another *without* the ability to legally bind the other.¹⁵ I call this "moral control". Some close personal relationships, such as those between parents and adult children or spouses, have this feature. Moral control is not the same as legal power. Consider the relationship between a person of weak character and a person of dominating will. The dominating personality may control the weaker one, even to the point of affecting decisions the weaker partner makes. But the power is not a legal one: If the dominant character purports to enter into a contract for the submissive one without authority or ratification, the law will not enforce the contract against the weak character. Correlatively, the stronger character is not subject to a duty to protect the interests of the other person.¹⁶

¹⁴See RESTATEMENT (SECOND) OF TRUSTS §173 cmt. d (1959). Today, a trustee must disclose information where necessary to protect a beneficiary's interests. UNIF. TRUST CODE §813(a), 7C U.L.A. 239 (Supp.). This would occur, perhaps, where the beneficiary might want to claim breach of fiduciary duty or otherwise seek equitable relief challenging the action of the trustee.

¹⁵See RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b(1) (2003); RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(1), at 36 (Tentative Draft No. 2, 2001).

¹⁶What fun would moral control be, if it had to be exercised in the best interests of the other party?

This is not to say that moral control is never legally relevant. The law has recognized that moral control – the “position of trust and confidence” – can give rise to special duties in making contracts, for example.¹⁷ It is also legally recognized in the law defining conflicts of interest. Thus, where a director is accused of being “dominated and controlled” by an interested director, the first director is deemed to be tainted by the interest.¹⁸ This is true even though the interested director’s power of control is not legally enforceable.¹⁹ However, these are cases where the law is attempting to determine the quality of an actor’s decision-making – whether a contract is truly based on consent or whether a director was acting based on her own good faith judgment. Moral control is not relevant for deciding whether a person has legal power over another’s person or property and thus owes a fiduciary duty.

II. The Relationship Between Shareholders and the Board

At the risk of stating the obvious, I now proceed to examine the legal relationship between the shareholders and board. To begin, it is worth noting that there are a variety of *actual* relationships the shareholders and the board may have. In small corporations, for example, the shareholders and the directors may be the same people. The relationship among those people will vary widely and may have no structure other than that required by law.²⁰

¹⁷*See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 161(d) (1979) (noting that non-disclosure is equivalent to an assertion when it concerns a fact that a person is entitled to know because of a “relation of trust and confidence”).

¹⁸*See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995).

¹⁹*See* Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984).

²⁰If the corporation has regular counsel, it may hold periodic meetings, either real or fictitious, of directors and shareholders.

Actual Relationships

In very large corporations, there may be no actual relationship at all between any of the shareholders and the board, except to the extent the board members themselves own shares and to the extent the occasional shareholder shows up at the annual meeting. The company will have an “investor relations” page on its website, but it may take a shareholder a while even to find it. The shareholders have invested in the hope that the company will make money, but they do not care how the company does so. In short, they are passive investors. As many others have pointed out, they are passive not only by choice, but because they lack the time, expertise, and incentive to participate in management.²¹ This will be especially true if their holdings are highly diversified. They rely on the board to make business decisions based on the board’s judgment and expertise, not based on some idea of what the shareholders might want (other than profitability). In this respect, one might say that the large publicly traded corporation functions as a republic rather than a democracy.²²

Even in large companies with dispersed shareholders, there are some matters that are of interest to the shareholders if only because the shareholders are required to vote on them: the election of directors, the amendment of the certificate of incorporation, and fundamental changes such as mergers and the sale of all or substantially all the assets. The procedures applicable to such matters, such as voting structures and antitakeover devices, are also relevant to the shareholders. In addition, any matter that reduces or enhances the likelihood that the board and

²¹See BAINBRIDGE, *supra* note X, at 201-203. Professor Bainbridge also notes that shareholder passivity has been a feature of corporate life for centuries, *see id.* at 196-197.

management will in fact seek to maximize the profitability of the enterprise (rather than their own wealth) will be important to a shareholder who is paying attention. Institutions, such as pension and mutual funds, are often shareholders who “pay attention” for a variety of reasons, and their “activism” has therefore attracted considerable scholarly attention.²³ Even institutional shareholders will nevertheless be largely passive with respect to day-to-day, or even relatively major, management decisions.

Other smaller corporations may operate on a true democracy or oligarchic model. Most shareholders will have representation on the board, but the degree to which they have influence will vary widely. In businesses owned by entrepreneurs and venture capital investors, for example, the relationship between the shareholders will be highly structured by contract, and the venture capitalists may expect to have direct input on business matters in some circumstances.²⁴ In family businesses, on the other hand, the patriarch or matriarch may completely dominate decision-making with the expectation that the other owners (who may be second or third generation family members) will tag along as best they can.²⁵

Legal Relationship: Principal and Agent?

²²This is presumably the origin of the title of Vice Chancellor Strine’s reply to Professor Bebchuk. *See Strine, supra note X. Cf. Bebchuk, supra note X, at 837* (describing the American corporation as a “representative democracy”).

²³*See infra* Part IV.

²⁴*See Joseph A. McCahery and Erik P.M. Vermeulen, Corporate Governance and Innovation: Venture Capital, Joint Ventures, and Family Businesses* (March 2006), ECGI Working Paper Series in Law No. 65/2006, available at <http://ssrn.com/abstract=894785>, at 27-28; 42-47.

²⁵*See id.* at 35-37. *See also* Phred Dvorak & Jaclyn Badal, *Relative Problems*, WALL ST. J., July 24, 2006, at B1.

The *actual* relationship between shareholders and boards can be and has been carefully examined from economic, behavioralist, finance and other perspectives. The *legal* relationship between shareholders and boards must, however, be examined from a legal perspective. That legal relationship is superimposed on the actual relationship (if any) between the board and the shareholders. As noted above, the shareholders elect the directors and vote on fundamental matters. Other than that, however, the shareholders have no legal role in the corporation and no further legal relations with the directors. They can bring a derivative suit and thereby attract the attention of the board, but there is no requirement that the board make itself available for shareholder input. The directors, meanwhile, are fiduciaries because they have legal power over the corporation (or, if you prefer, the assets and legal rights and obligations that comprise the corporation). To whom are those fiduciary duties owed? The law clearly describes those duties as owed to the corporation and all its shareholders.²⁶ Most of the time this proposition is not particularly troublesome as a practical matter. The shareholders are the ultimate, residual beneficiaries of the corporate enterprise; if the corporation is profitable, the shareholders' investment will increase in value and everyone will be happy even if that profit is achieved by considering interests other than the shareholders'. Unfortunately, this fact has gotten caught up in a policy debate between those who believe that corporate boards can or should consider or in some cases prefer other interests (such as those of employees, customers, and all future life on the planet) to those of the shareholders. Reacting to this position, others have argued for a

²⁶See *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946, 954 (Del. 1985); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939). See also MODEL BUSINESS CORPORATION ACT § 830 (a)(3) (1984).

“shareholder primacy norm” that requires that boards consider shareholders, and only shareholders, in pursuing corporate policy.²⁷

Of course, if shareholders’ interests are primary, then the primary problem of corporate governance is the “agency problem” of boards and management preferring their own interests to those of the shareholders. Thus, the shareholder primacy norm has led by extension to the idea that shareholders should have the power to control the board in order to minimize these agency costs. This use of the word “agency” has even led some people to refer to the shareholders as “principals” and boards as “agents” of the shareholders.²⁸ Principals have the right to control their agents, and agents owe fiduciary duties to their principals, so this misuse of agency law terminology supports the proposition that shareholders should have more control over boards and that boards should seek to advance only the interests of the shareholders. However, this “principal/agent” analysis is simply and unequivocally wrong as a legal matter, and those who advocate it are distorting the law to serve their political goals.

As is often the case, the two sides of the so-called shareholder/stakeholder debate have taken their arguments to untenable extremes. No sane business person would suggest that a board should ignore the interests of the corporation’s employees and customers in order to enhance shareholder value. The idea is oxymoronic. Similarly, no sane person should expect the board of a for-profit corporation intentionally to reduce long-term shareholder value in order to improve the lot of workers or whales. In many instances, a concern for the interests of

²⁷For a summary of this debate and discussion of the relevant issues, see BAINBRIDGE, *supra* note X, at 410-424.

employees, customers, and even the general public will improve the profitability of the business and therefore enhance shareholder value.²⁹ It is only in rare (but often high-profile) instances, such as hostile takeovers, that a board's seeking to protect the long-term interests of the business might adversely affect the shareholders' ability to realize value on their investments.³⁰

Defining the interests that the board should consider in carrying out its fiduciary responsibilities is not the same, however, as defining the beneficiary of that fiduciary duty. A trustee, for example, is supposed to seek to effectuate the settlor's intent.³¹ The settlor is not, however, the beneficiary of the trust. Similarly, the trustee owes a fiduciary duty to the trust beneficiaries, but those beneficiaries do not ordinarily have any right to control the acts of the trustee.³² Thus, the shareholder/stakeholder debate does not necessarily have anything to do with the board's fiduciary duties.

The merits of the shareholder/stakeholder debate are not relevant here, however. The point is to identify the legal relationship between the board and the shareholders without

²⁸See WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 97 (2003) (referring to the board as a "quasi-principal" and as the "economic agent" of the shareholders). See also *infra* notes X and accompanying text.

²⁹See BAINBRIDGE, *supra* note X, at 413. See also Olubunmi Faleye & Emery A. Trahan, *Is What's Best for Employees Best for Shareholders* (May 2006), available at <http://ssrn.com/abstract=888180>.

³⁰An egregious example of this occurred in *Paramount Communications, Inc., v. Time Inc.*, 571 A.2d 1140 (Del. 1989), when the Time board denied the shareholders the opportunity to sell their shares at a 400% premium in order to protect the long-term interests of the company, including its editorial "culture". See also BAINBRIDGE, *supra* note X, at 412-413 (discussing *Schlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. 1968)).

³¹See IIIA SCOTT & FRATCHER, *supra* note X, § 232 at p. 7 (noting that the terms of the trust can determine how a trustee should balance the interests of multiple beneficiaries).

³²See *supra* note X.

allowing the extra-legal rhetoric and economic jargon to mislead us. Is the board the agent of the shareholders? An agent is a person who has agreed to act on behalf of another person (the principal) and subject to that person's control.³³ The principal has a complete right of control over the agent, which serves to offset the fact that the principal is vicariously liable for all the acts of the agent. The agent owes fiduciary duties to the principal, including the duty to turn over to the principal all profits or other benefits arising from the relationship. The relationship between shareholders and directors has none of these features, and it should therefore be apparent that a board is not an agent of the shareholders.³⁴

Unfortunately, however, the idea that shareholders are the board's principal has acquired some authority. A few courts have used the language of principal and agent when discussing the relationship between the shareholders and the board. The most important of these cases is *Blasius Industries v. Atlas Corp.*,³⁵ in which Chancellor Allen held that a board needed a compelling justification to interfere with a shareholder vote for directors. In addition to noting the importance of the shareholder franchise to the "legitimacy of directorial power,"³⁶ the Chancellor stated that "a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, *as between the principal and the agent*, has authority with respect to a matter of internal corporate

³³See RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958).

³⁴See RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(2), at 37 (Tentative Draft No. 2, 2001).

³⁵See *Blasius Industries, Inc.*, 564 A.2d at 659-660.

³⁶*Id.* at 659.

governance.”³⁷ Moreover, that “will be true in every instance in which an incumbent board seeks to thwart a shareholder majority.”³⁸ Judicial review of a board’s interference with a shareholder vote “involves a determination of the legal and equitable obligations of *an agent towards his principal*. This is not . . . a question that a court may leave to the *agent* to decide”³⁹ Although the Delaware Supreme Court has approved the “basic tenets” of *Blasius*, it has generally done so with reference to the legitimating power of the shareholder franchise, not with reference to the Chancellor’s use of agency law.⁴⁰ The exception to this appears in *MM Companies, Inc. v. Liquid Audio, Inc.*,⁴¹ in which the Supreme Court quoted, without comment, a long passage from *Blasius* that includes the language quoted above describing the shareholders as the board’s principal.⁴²

³⁷*Id.* at 659-660 (emphasis added).

³⁸*Id.* at 660. Arguably, under the Chancellor’s reasoning a board would need a compelling justification to, for example, refuse to approve an amendment to the certificate of incorporation that had been approved by a majority vote of the shareholders. *But see* Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 42-45 (2004) (arguing that the board has a duty to make an independent determination about proposals receiving majority shareholder approval, but not discussing *Blasius*).

³⁹564 A.2d at 660 (emphasis added).

⁴⁰*See Unitrin*, 651 A.2d at 1378 (describing the franchise as the “essence of corporate democracy”); *Paramount Comm.*, 637 A.2d at 42 (referring to the “overriding importance of voting rights”); *Centaur Partners IV*, 582 A.2d at 927 (describing the franchise as the “ideological underpinning upon which the legitimacy of directorial power rests”); *Preston v. Allison*, 650 A.2d 646, 649 (Del. 1994) (describing the franchise as “a fundamental part of our corporate law”).

⁴¹813 A.2d 1118 (Del. 2003).

⁴²*Id.* at 1128-1129.

If the shareholders are the board's principal, then the board is obligated to obey the shareholders' wishes without considering other interests and without exercising independent judgment.⁴³ This is a result that many people would prefer, but it is clearly not the law. In *Unisuper Ltd. v. News Corp.*,⁴⁴ Chancellor Chandler argued that the contract in question, which bound the board not to renew a poison pill without shareholder approval, was not void despite the fact that it sterilized the board's discretion, a feature that ordinarily invalidates a contract. The court reasoned, among other things, that the contract essentially permitted the shareholders, as principals, to make their wishes known to their agents, the board. A month later, in further proceedings in the same case, the Chancellor described the earlier discussion as an "analogy" to agency law principles, noting that shareholders "rarely speak with one voice," and observing that there may be times when a director's duty to the corporation requires her to act against the shareholders' immediate wishes.⁴⁵ The board is obligated to exercise its own judgment and cannot abdicate its responsibilities by tossing decision-making into the shareholders' collective lap.⁴⁶

Legally speaking, the principal of the board, and of anyone else exercising corporate powers, is the corporation.⁴⁷ While the idea of the corporation as a separate legal person is now

⁴³Even under *Blasius*, such a relationship might be limited to governance matters and not extend to the board's actions with respect to the operation of the business. See *Blasius*, 564 A.2d at 660.

⁴⁴2005 WL 3529317 (Del. Ch. Dec. 20, 2005) at *8.

⁴⁵*Unisuper Ltd. v. News Corp.*, 2006 WL 207505 (Del. Ch. Jan. 20, 2006) at *3.

⁴⁶See *Paramount Comms., Inc., v. Time Inc.*, 571 A.2d at 1154 (Del. 1989).

⁴⁷See Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1074 n.4 (1983). On the other hand, when the board is

often ridiculed as an outmoded over-simplification (at best), it is a handy shorthand term for the multitudinous interests involved in the profit-making enterprise. Even leaving other “stakeholders” out of the picture, the shareholders still do not represent the sole corporate interest. Unless there is only one shareholder, the shareholders do not have a single unitary interest and cannot be treated as a corporate “principal” with the board as its agent. And even if the shareholders did have a single interest, any subset of the shareholders (i.e., a majority) would still be at best an agent of the whole group, and not a principal. Moreover, the board’s authority extends to the assets legally owned by the corporation, not by the shareholders. The shareholders have no power over the corporate property and therefore could not delegate that power to the board or anyone else.⁴⁸ The shareholders also have no liability for the board’s

negotiating a transaction that will result in the shareholders’ interests in the corporation being sold or converted, the board is literally acting on behalf of the shareholders, not the corporation, and is therefore the shareholders’ agent. *See In re Cox Comms., Inc., S’holder Litig.*, 879 A.2d 604, 619 (Del. Ch. 2005); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 108 n.52 (Del. Ch. 1999).

⁴⁸There are some cases that treat the board as a delegate of the shareholders. *See Grimes v. Donald*, 1995 WL 54441 at *7 (Del. Ch. Jan. 11, 1995); *Alford v. Shaw*, 349 S.E.2d 41, 51 (N.C. 1986); *Appeal of Armed Forces Co-op. Insuring Assn.*, 625 P.2d 11, 16 (Kan. App. 1981); *Moore v. Conover*, 195 A. 833, 838 (N.J. Eq. 1937); *Severance v. Heyl & Patterson, Inc.*, 187 A. 53, 58 (Pa. Super. 1936). This has always been wrong; corporations, and board powers, are established by legislative act, and shareholders have not always even had the power to choose the members of the board. The Dutch East India Company (the VOC), one of the world’s first modern business corporations, was organized by the Dutch States General in 1602 as a combination of smaller, city-based companies. *See Ella Gepken-Jager, Verenigde Oost-Indische Compagnie (VOC): The Dutch East India Company, in VOC 1602-2002: 400 YEARS OF COMPANY LAW* 41, 47 (Ella Gepken-Jager et al. eds., 2005). The business was managed by directors, who were appointed by governors representing the several cities (“chambers”) included in the combination. *See id.* at 54-55. The governors were initially appointed by the States General; thereafter they were supposed to be elected by large shareholders in each chamber but in practice they simply appointed their own successors. *See id.* at 55-56. As a result of complaints from investors, some accountability structures were put in place, but they protected only the “major shareholders”. *See id.* at 57. The Danish East India Company, established in 1616, did away with the chamber system in favor of direct selection of the governors by the “general meeting” of the shareholders; however, that system quickly changed to

actions, unlike a principal. In sum, the relationship between shareholders and the board bears none of the indicators of a principal/agent relationship.⁴⁹

The Corporate Contract: Corporate Primacy v. Duties to Shareholders

Although the board and shareholders are not in a principal/agent relationship, they are clearly in a contractual relationship, a fact which has been recognized at least since *Dartmouth College*.⁵⁰ The certificate of incorporation is a contract that binds the shareholders and the board, subject to the requirements of the incorporation statute of the state of incorporation. Identifying the relationship between the board and the shareholders as contractual does not tell us much, of course; agency is often created by a contractual relationship as well. It is probably possible to create a corporation that includes an agency relationship between the board and the

one where shareholder control was made more indirect. See Karsten Engsig Sørensen, *The Danish East India Company*, in VOC 1602-2002: 400 YEARS OF COMPANY LAW, *supra*, at 107, 113-118.

⁴⁹See Benedict Sheehy, *Shareholders, Unicorns and Stilts: An Analysis of Shareholder Property Rights*, 6 J. CORP. L. STUDS. 165, 201 (2006).

⁵⁰See *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 627 (1819). See also *Rogers v. Lafayette Agric. Works*, 52 Ind. 296 (1875) (stating that purchase of stock constitutes a shareholder's agreement to management by the board of directors). This contract may be somewhat fictitious in large or established companies, where the contract was entered into by persons far removed from the current shareholders. Cf. Bebchuk, *supra* note X, at 862-865, 888-890 (describing lack of shareholder power to amend or control amendments to the charter); ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 186-195 (1932) (same). Nevertheless, the shareholders' participation in every corporation actually originates with the filing of the (contractual) charter. The corporate contract is therefore much more real than the social contract purportedly legitimizing government.

shareholders, but most corporate charters do not create any identifiable relationship between the parties other than shareholder/director. Pursuant to the corporate contract, the shareholders commit capital to the operation of a business, and the statute provides that the business will be managed by a board of directors. They are, as Professor Bainbridge has described it, joined in the corporate nexus.⁵¹ The shareholders have the right by statute to select and remove the board; this provides at least some protection for their investment. They also have the right to approve fundamental changes, which are in effect amendments of the basic contract. These are important rights that courts will protect strenuously.⁵² However, they are rights created by the statute and charter and are therefore part of the corporate contract. Unless a contract expressly provides otherwise, it does not give one party the right to control what the other party does. Contracts also do not, in themselves, give rise to fiduciary duties.⁵³ Thus, identifying the relationship as a contractual one tells us nothing about the fiduciary duties of the board or the amount of control the shareholders have over the board. Only the terms of the contract can tell us that, and most of the relevant “terms” of the contract among the shareholders, board, and corporation are set by law.⁵⁴

The primary legal determinant of the relationship between the shareholders and the board is embodied in provisions such as Section 141(a) of the Delaware General Corporation law,

⁵¹See BAINBRIDGE, *supra* note X, at 200.

⁵²See *McIlquham v. Feste*, 2002 Del. Ch. LEXIS 8, at *6 (Del. Ch. Feb. 13, 2004); *Rohe v. Reliance Training Network, Inc.*, 2000 WL 1038190 at *11 (Del. Ch. July 21, 2000) (directors must be elected regularly and can be removed by the shareholders without limitation).

⁵³*Cf. Wal-Mart Stores, Inc.*, 901 A.2d at 114.

⁵⁴Whether those terms are mandatory or subject to change by agreement of the parties is not relevant to this analysis.

which provides that “the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.”⁵⁵ Because the shareholders are the residual claimants on the corporate assets they comprise “the corporation” when everyone else is gone. Because the board’s duties are owed to the “corporation” or the shareholders as a group, the board should seek to enhance the profitability of the corporation. As discussed above, the method used to enhance profitability, and the appropriate time horizon, are matters for the board’s discretion.⁵⁶ Not only do the shareholders not have the power to interfere in the board’s management,⁵⁷ but the shareholders’ power to hold the board to account for its actions is also limited.⁵⁸ What should a board do, however, when the interests of the corporation – that is, profit maximization – conflict with those of a shareholder or group of shareholders? This situation arises in a number of ways. There are the occasional well-known cases involving socially responsible shareholders who seek to have the corporation cease some profitable but socially injurious line of business, in which the courts usually rule that such decisions are within the purview of the board.⁵⁹ There are also the takeover cases, which state that a board may take action against a shareholder who poses a threat to “corporate policy and effectiveness” if the board’s response is proportionate to the threat and not intended to protect the incumbent

⁵⁵DEL. CODE ANN tit. 8 § 141(a) (year). See *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000).

⁵⁶See *supra* notes X and accompanying text.

⁵⁷See *Paramount Comms., Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994).

⁵⁸See BAINBRIDGE, *supra* note X, at 207.

⁵⁹See, e.g., *State ex rel. Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971) (holding that attempting to force Honeywell to stop manufacturing fragmentation bombs was not a proper purpose for a shareholder’s books and records request).

directors' positions.⁶⁰ Other cases have stated, at least in dicta, that a board can thwart the will of a majority of the shareholders, or of a sole majority shareholder, if it has a sufficiently compelling reason for doing so.⁶¹

The rule preferring corporate profitability to the wishes of a subset of shareholders is consistent with the principle that a contract is invalid if it sterilizes the board's discretion to act consistently with its fiduciary duties, unless *all* the shareholders agree and the corporation's creditors are protected.⁶² To prefer the interests of some shareholders to the interests of the corporation as a whole (which embodies the common wealth-maximizing interests of all the shareholders, even if it does not embody the peculiar interests of particular shareholders) would be to act against the interests of the remaining shareholders. Similarly, the law is clear that a board must protect the interests of a minority shareholder from injury caused by a majority shareholder.⁶³ Even a director who was named to the board by a specific shareholder is

⁶⁰*See* Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985).

⁶¹*See* Mendel v. Carroll, 651 A.2d 297, 299, 304, 306 (Del. Ch. 1994); Blasius Industries v. Atlas Corp., 564 A.2d 651, 661 (Del. 1988) (blocking shareholder vote for directors); Phillips v. Insituform of North America, Inc., 1987 WL 16285 at *6, *7, *8 (Del. Ch. Aug. 27, 1987) (diluting majority shareholder's holdings).

⁶²*See infra* note X.

⁶³*See, e.g.*, McMullin v. Beran, 765 A.2d 910, 919-920 (Del. 2000); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

obligated to act in the interests of all the shareholders or the corporation as a whole,⁶⁴ and can, unless the charter specifies otherwise, be removed for cause by the other shareholders.⁶⁵

There are, however, a few cases that seem to contradict the corporate-primacy principle. In *VGS, Inc. v. Castiel*⁶⁶ the board of the company (an LLC) consisted of three directors: the majority shareholder (Castiel), his designee, and the minority shareholder. The minority shareholder convinced the Castiel designee that Castiel's control was bad for the company, and they cooked up a scheme to eliminate his control. "Many LLC employees, and even some of Castiel's lieutenants, testified that they believed it to be in the LLC's best interest to take control from Castiel."⁶⁷ Nevertheless, the court held that the two members of the board had "failed to discharge their *duty of loyalty to [Castiel]* in good faith".⁶⁸ The relevant fact in *VGS*, however, is that the board acted without notice to Castiel, another director, because if it had provided notice he would have instantly exercised his right to remove his designee from the board and appoint someone more loyal to him. In doing this, he would have been acting as a shareholder and he

⁶⁴See, e.g., *McMullin*, 765 A.2d at 923; *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Phillips v. Insituform of No. America, Inc.*, 1987 WL 16285 at *10 (Del. Ch. Aug. 27, 1987).

⁶⁵See *Rohe v. Reliance Training Network, Inc.*, 2000 WL 1038190, at *12-13 (Del. Ch. July 21, 2000).

⁶⁶2000 WL 1277372 (Del. Ch. 2000).

⁶⁷*Id.* at *2.

⁶⁸*Id.* at *4 (emphasis added). See also *Benihana of Tokyo, Inc., v. Benihana, Inc.*, 891 A.2d 150, 185 n.215 (stating that a director's seeking to dilute the position of a majority owner who might pose a threat to the corporation "could constitute an improper purpose" for action).

would not have been bound by fiduciary duties.⁶⁹ In other words, the *secret* board action had the primary motive of depriving a shareholder of his right to vote for directors, which, under *Blasius*⁷⁰, constitutes a breach of the directors' duty in the absence of a compelling justification.⁷¹

In other cases where individual shareholders or groups of shareholders had the right, by contract or pursuant to the certificate of incorporation, to appoint one or more directors, courts have recognized that those directors are intended to serve a specific function benefiting the individual shareholder and not necessarily the corporation as a whole.⁷² Courts have held that director-designees have the right to share information obtained from their board positions with the shareholders who appointed them,⁷³ and that it was reasonable for a board to consult a 40%

⁶⁹See 2000 WL 1277372 at *4. See also *Pepsi-Cola Bottling Co. of Cincinnati v. Woodlawn Cannery, Inc.*, 1983 WL 18017 at *15-16 (Del. Ch. Mar. 14, 1983) (holding that a 44% shareholder was entitled to vote in its own interest even if doing so caused substantial harm to the corporation).

⁷⁰564 A.2d 651 (Del. Ch. 1988). See *supra* notes X and accompanying text.

⁷¹Professor Eisenberg convincingly argues that the board in *VGS* violated its duty of good faith by manipulating the corporate process in a way that violates corporate norms. See Eisenberg, *supra* note X, at 51-57. He does not discuss *Blasius*.

⁷²See *Moore Business Forms, Inc., v. Cordant Holdings Corp.*, 1996 WL 307444 at *6 (Del. Ch. June 4, 1996) (noting that purpose of shareholder's right to designate director was to protect the shareholder's interests which were different from, and might conflict with, those of corporation). See also *Benihana of Tokyo, Inc.*, 891 A.2d at 165 n.76, 166, 187 (discussing position of director-designees).

⁷³See *Moore Business Forms, Inc., v. Cordant Holdings Corp.*, 1996 WL 307444 at *4 (Del. Ch. June 4, 1996); *Kortum v. Webasto Sunroofs Inc.*, 769 A.2d 113, 121 (Del. Ch. 2000).

shareholder before acting.⁷⁴ The courts, at least in Delaware, seem to take a pragmatic approach, protecting the bargained-for rights of individual shareholders vis-a-vis the corporation, but protecting the corporation and other shareholders when those individual rights create conflicts that were not specifically foreseen or foreseeable at the time the special rights were established.⁷⁵ In sum, the law elevates the interest of the corporation above the interests of any single shareholder and even above the interests of the shareholders as a group unless the corporate contract provides otherwise.⁷⁶

III. The Close Corporation Shareholder Debate, Again

The Enron scandals have cast some interesting light on the debate over shareholder fiduciary duties. First, the arguments in favor of controlling shareholders owing fiduciary duties tend to be based on the vulnerable position of minority shareholders, of whom the archetype is Euphemia Donahue.⁷⁷ Close corporations are usually defined as those with “a small number of stockholders, the absence of a market for the corporation’s stock, and substantial shareholder

⁷⁴See *In re Western Nat’l Corp. Shareholders Litig.*, 2000 WL 10192 at *8 (Del. Ch. 2000). *But see* *McMullin v. Beran*, 765 A.2d 910, 924 (Del. 2000) (holding that directors must use independent judgment in making decision regardless of interests of controlling shareholder).

⁷⁵*Cf.* *Moore Business Forms, Inc.*, 1996 WL 307444 at *6 (noting that conflict of interest was foreseen); *McIlquham v. Feste*, 2002 Del. Ch. LEXIS 8, at *7-8 (Del. Ch. Feb. 13, 2002) (refusing to protect majority shareholder’s right to control board when right had not been bargained for at the time minority shareholder received right to designate directors).

⁷⁶See *Strine*, *supra* note X, at ___; *Brownstein and Kerman*, *supra* note X, at 42-45; *Brudney*, *supra* note X. The right of shareholders to elect and remove directors is, of course, part of the corporate contract.

⁷⁷See *Donahue v. Rodd Electrotpe Co.*, 328 N.E.2d 505 (Mass. 1975).

participation in the management of the corporation”.⁷⁸ In a close corporation, shareholders “usually expect employment and a meaningful role in management, as well as a return on the money paid for [their] shares.”⁷⁹ Because of the majority-rule nature of the corporation, the majority shareholder, through control of the board of directors, “has the ability to take actions that are harmful to the minority shareholders’ interests.”⁸⁰ “Standard [abusive] techniques include the refusal to declare dividends, the termination of a minority shareholder’s employment, the removal of a minority shareholder from a position of management, and the siphoning off of corporate earnings through high compensation to the majority shareholder.”⁸¹ The minority shareholder is faced with an “indefinite future with no return on the capital he or she contributed to the enterprise,”⁸² and, unlike a shareholder in a public corporation, cannot “simply sell[] its shares on the market.”⁸³

In contrast, let us consider the situation of those fortunate shareholders in public corporations, such as the shareholder-employees of Enron or WorldCom. Most of their wealth was tied up in stock of their employer, and they were dependent for cash flow on employment by the company because the companies did not pay dividends. They were at the mercy of management, who were able to extract cash from the company in ways the “minority” were not, such as through high compensation, other perquisites of office, and self-dealing. When

⁷⁸Moll, *supra* note X, at 888.

⁷⁹*Id.* (quoting Thompson, *supra* note X, at 702).

⁸⁰*Id.* at 889.

⁸¹*Id.* at 890.

⁸²*Id.* at 891 (quoting Thompson, *supra* note X, at 703).

management's wrongdoing was exposed, their employment was terminated, their investments became worthless, and they had no ready market for their shares. This is exactly the predicament in which Mrs. Donahue found herself.⁸⁴

One might argue that the Enron shareholder-employees made their own beds by failing to diversify their retirement account holdings. By investing solely or primarily in the stock of their employer, they voluntarily (although perhaps unwisely) sealed their fate. The same is true of "oppressed" shareholders in close corporations, however, who willingly (although perhaps unwisely) chose to invest as minority shareholders.⁸⁵ Furthermore, the fact of shareholder participation in management, which is generally treated as a feature of closely held corporations,⁸⁶ is rapidly increasing as a feature of publicly held corporations as well. This phenomenon takes two forms, and each form raises a number of issues, as discussed below. It also serves to demonstrate that the argument in favor of shareholder fiduciary duties based on the uniqueness of the position of shareholders in close corporations rests on a false premise.⁸⁷

⁸³*Id.*

⁸⁴Actually, Mrs. Donahue was better off than the Enron employees. She continued to hold shares in a valuable company, although she was unable to liquidate her investment at a price she liked. If she had retained her stock, she might eventually have earned a substantial return when the company was sold or liquidated.

⁸⁵Some minority shareholders wind up in that position because their public company has been taken over by a controlled corporation, but in that case the law governing takeovers protects them. *See Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994) Some people inherit their minority shares, in which case it is difficult to see why they should not also inherit the unfavorable contractual position assented to by their forebears.

⁸⁶*See, e.g., Donahue*, 328 N.E.2d at 511; Moll, *supra* note X, at 888.

⁸⁷I have made this argument previously; the Enron scandals merely illustrate my point. *See Dalley, supra* note X, at 193-199.

IV. Shareholder Activism Part I

The more interesting post-Enron development involves the blossoming of shareholder activism, a bud that has hung tantalizingly from the vine for many years.⁸⁸ The term “shareholder activism” is often used loosely to mean anything done by a shareholder in a public company other than passively voting with management. However, shareholder activism comes in two varieties: efforts by institutional investors (usually mutual and pension funds) and reformers to improve corporate governance, often by removing anti-takeover devices; and efforts by large individual investors or hedge funds to cause specific changes in the way the company is being run.⁸⁹ I discuss each of these in turn.

Lucian Bebchuk’s proposal to give shareholders more power in corporate governance is a hot controversy on the academic corporate law circuit these days.⁹⁰ Bebchuk proposes that

⁸⁸In 1992, the SEC adopted new rules for disclosure of executive compensation intended to “improve shareholders’ understanding of all forms of compensation paid to senior executives and directors, the criteria used by the board of directors in reaching compensation decisions, and the degree of relationship between compensation and corporate performance. . . .” *Executive Compensation Disclosure*, Exchange Act Rel. No. 31327, Oct. 16, 1992, FED. SEC. L. REP. (CCH) 1992 Transfer Binder ¶ 85,056 at 83,416. On the same day, the SEC adopted rules to remove “unnecessary government interference in discussions among shareholders of corporate performance and other matters of direct interest to all shareholders.” *Regulation of Communications Among Shareholders*, Exchange Act Rel. No. 31326, Oct. 16, 1992, FED. SEC. L. REP. (CCH) 1992 Transfer Binder ¶85,501 at 83,353. It was widely understood that the latter set of rules would permit, if not encourage, increased involvement in corporate governance matters by institutional investors.

⁸⁹See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* 15-17 (July 2006), U. of Penn. Inst. for Law & Econ. Research Paper No. 06-16, available at SSRN: <http://ssrn.com/abstract=919881>.

⁹⁰See generally Bebchuk, *supra* note X; Stephen M. Bainbridge, *Director Primacy and Shareholder Empowerment*, 119 HARV. L. REV. 1735 (2006); Strine, *supra* note X.

shareholders be given greater power in “rules of the game” matters – changes to the governance provisions in the certificate of incorporation – which are traditionally within the shareholders’ vetitive jurisdiction (although that jurisdiction is coincident with the board’s).⁹¹ He also proposes that shareholders be given the power to choose, in advance, to make certain business decisions,⁹² and to initiate “end of the road” decisions such as sale or dissolution of the company.⁹³ Leaving aside the merits of these proposals, they raise questions about the fiduciary duties that would attend the shareholders’ increased powers.⁹⁴ Shareholder power over rules-of-the-game decisions seems innocuous enough. Institutional investors have been making governance proposals for years.⁹⁵ As Bebchuk notes, those proposals often do not result in actual change, even when they receive a majority vote of the shareholders.⁹⁶ This is because changes to the certificate of incorporation require board, as well as shareholder, approval.⁹⁷ Bebchuk wants to change this rule.

As noted above, the certificate of incorporation is a contract to which shareholders are deemed to be parties by virtue of their share ownership.⁹⁸ Unlike most contracts, this contract

⁹¹See Bebchuk, *supra* note X, at 865.

⁹²See *id.* at 892.

⁹³See *id.* at 895-896, 901.

⁹⁴Vice Chancellor Strine at least implicitly recognizes these problems. See Strine, *supra* note X, at ____.

⁹⁵See Kahan & Rock, *supra* note X, at 15-16.

⁹⁶See Bebchuk, *supra* note X, at 852-856.

⁹⁷See DEL. GEN. CORP. L. § 242(b)(1).

⁹⁸See *Centaur Partners IV v. National Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990).

can be changed without a party's consent, but it must be done with the approval of both the board and a majority of the shareholders. The shareholders do not owe any duties when they do this, but the board does. In fact, the board's duties when tinkering with governance are heightened.⁹⁹ If a majority of the shareholders has the power to change the certificate unilaterally, the dissenting shareholders will lose the protection provided, at least theoretically, by the board's duty to act in the best interests of the corporation and all the shareholders.¹⁰⁰ This problem may sound more theoretical than actual, but it could cause real harm to dissenting shareholders.¹⁰¹ In fact, the board's fiduciary duties are the only protection for minority

⁹⁹See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994); *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1378 (Del. 1995).

¹⁰⁰See Kahan & Rock, *supra* note X, at 40. The board's duty to prevent charter amendments that are not in the best interests of the corporation and all its shareholders is explored in Brownstein & Kirman, *supra* note X, at 42-45. Some of the language in *Blasius Industries Inc.*, 564 A.2d at 660, suggests that a board is always obligated to respect the expressed wishes of a majority of the shareholders on a corporate governance matter. Because the Delaware statute gives the power to initiate a charter amendment to the board, however, it would be odd, at least, to hold that the board did not have discretion in exercising that power. See also *supra* Part II.

¹⁰¹Suppose I am a shareholder in a publicly traded company with a staggered board, and I like the staggered board because I do not want the company be taken over (perhaps because I live in the town where it has its headquarters, or because of my tax situation). In fact, I purchased the shares, and became subject to the terms of the certificate of incorporation, knowing about the staggered board. Corporate law allows those contract terms to be changed without my consent if the board and a majority of the shareholders agree. Although the majority of the shareholders can act selfishly to change the certificate to, for example, cause a short-term improvement in the price of the stock by increasing the likelihood of a takeover, the board must consider the interests of the corporation as a whole. It may believe, for example, that the staggered board, together with a poison pill, gives it power to negotiate with a bidder to protect shareholder interests, like mine, in a takeover, and therefore refuse to remove the staggered board provisions. As a "minority" shareholder, I am protected by the board's veto.

shareholders in states that (correctly) do not impose duties on controlling shareholders.¹⁰² If the shareholders are to get the power to act unilaterally to legally bind all the other shareholders through an amendment to the corporate charter, they should also be subject to some corresponding duty. One option is to apply the contractual duty of good faith and fair dealing to shareholders' acting to change the certificate of incorporation. This rule would recognize that the shareholders are exercising a contract right that may affect the other parties' legitimate expectations under the existing contract.¹⁰³ Alternatively, the dissenting shareholders could be given appraisal rights, which is consistent with the current rule giving shareholders appraisal rights when they dissent from a merger, which is a change in the fundamental terms of their investment without their consent.¹⁰⁴

Bebchuk's "let the shareholders make business decisions" proposal is more troubling. Delaware law provides that shareholders may elect to manage the corporation in statutory close corporations, but when they do so they are subject to the same duties as directors.¹⁰⁵ This rule should apply to any shareholder or group of shareholders that takes control in lieu of the board, even in a public company, for the same reason: whoever has power over the corporate property owes a fiduciary duty to the corporation and all its shareholders. Bebhuk's proposal is

¹⁰²See *McMullin v. Beran*, 765 A.2d 910, 920 (Del. 2000); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42-43 (Del. 1994).

¹⁰³See STEVEN J. BURTON & ERIC G. ANDERSON, *CONTRACTUAL GOOD FAITH* § 2.3.3 (1995).

¹⁰⁴Originally, mergers required a unanimous vote of the shareholders. Appraisal rights compensated the shareholders for the loss of their veto power. See WILLIAM J. CARNEY, *MERGERS AND ACQUISITIONS* 19 (2000).

¹⁰⁵See DEL. GEN. CORP. L. § 351 (DEL. CODE ANN. tit. 8 § 351).

somewhat less radical than full shareholder control. He proposes that shareholders be able to specify in advance that they (and not the board) will have the power to make certain business decisions, including those involving acquisitions, distributions, and executive compensation.¹⁰⁶ In effect, Bebchuk is trying to give the shareholders the power of a principal to control its agent, the board. As noted above, this is not the existing legal relationship between the shareholders and the board. That relationship could be changed, of course, and that is the essence of Bebchuk's proposal. Under that proposal, however, a group of the shareholders – the majority – would be given authority to bind, and therefore become the agent of, the whole group or the corporation. That majority should therefore be subject to an agent's fiduciary duties when exercising those discrete powers.¹⁰⁷

How might this work in practice? Bebchuk anticipates that the business decisions that shareholders are most likely to take over are those that are “game-ending” (such as a sale of the company) and “scaling down” (such as the spin-off of a division or a distribution of cash-on-hand),¹⁰⁸ because those are decisions in which agency costs between shareholders and management are particularly high.¹⁰⁹ However he acknowledges that under his proposal any decision is eligible to be taken over by the shareholders.¹¹⁰ So, for example, the shareholders of

¹⁰⁶See Bebchuk, *supra* note X, at 895.

¹⁰⁷In the usual case, a majority shareholder does not owe fiduciary duties because it does not have any legal power over anyone. See Dalley, *supra* note X, at 207. Under Bebchuk's proposal, a majority of the shareholders would have legal power and should therefore be subject to concomitant duties.

¹⁰⁸See Bebchuk, *supra* note X, at 892.

¹⁰⁹See *id.* at 895.

¹¹⁰See *id.*

a corporation might add a provision to the certificate of incorporation requiring that the corporation distribute as a dividend all cash in excess of some amount. The point of this provision would be to prevent management from engaging in “empire-building”.¹¹¹ The board, however, may believe that technological advances are likely to result in increased competitive pressures in the intermediate term, and that “hoarding cash” is important to protecting the long-term viability of the business.¹¹² Alternatively, the board may be (quietly) pursuing a business opportunity that would provide an attractive rate of return on a cash investment. In either case, the board will be unable to fulfill its fiduciary duty to act in what it believes to be the best interests of the corporation and all its shareholders, because a majority of the shareholders have eliminated its discretion with respect to certain aspects of the business. This is a gross violation of fundamental corporate principles, which invalidate restrictions on the board’s ability to act consistently with its fiduciary obligations.¹¹³ Although such a restriction in the certificate of incorporation would probably be valid under current law,¹¹⁴ under current law the certificate can only be amended with the board’s approval¹¹⁵ – approval that is itself subject to fiduciary

¹¹¹*See id.* at 902.

¹¹²*See, e.g.,* Aaron O. Patrick, *James Murdoch Opens the Wallet*, WALL ST. J., Aug. 18, 2006, at C1.

¹¹³*See* *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d at 51. Nor would this provision fall under *Galler v. Galler*, 203 N.E.2d 577 (Ill. 1964), which validated restrictions on the directors that were agreed to by *all* the shareholders.

¹¹⁴*See* DEL. GEN. CORP. L. §§ 102(b)(1), 141(a)(1).

¹¹⁵*See* DEL. GEN. CORP. L. § 242(b)(1).

standards. Bebchuk's proposal would give the power to hamstring the board to a majority of the shareholders acting unilaterally.¹¹⁶

When a board makes decisions, it has a fiduciary duty to act in the best interests of the corporation and all its shareholders. The decision is protected by the business judgment rule, however, if it is made by a fully informed and disinterested board acting in good faith. What about the shareholders? Must their decision be fully informed, disinterested, and in good faith? It is not clear that the shareholders would be subject to any fiduciary duty in making their decision, and therefore that they would be under any obligation to become informed¹¹⁷ or to make the decision in the best interests of the corporation. Traditionally, shareholders have been permitted to act completely selfishly when voting, even in the presence of conflicts of interest.¹¹⁸ Furthermore, it would be impossible to impose fiduciary duties on the ephemeral majority of shareholders who made the decision to amend the certificate.¹¹⁹ The fact that the shareholders' decision to take control of an issue must occur in advance makes it even more difficult to hold

¹¹⁶Not surprisingly, corporate executives have taken a dim view of giving shareholders control over even rules-of-the-game decisions, arguing that "you run the risk of a . . . board being unable to make bold decisions that are unpopular with any of these constituencies [e.g., pension funds, mutual funds, and hedge funds] but in the best interests of the company." Alan Murray, *CEOs Get Off the Ropes on Executive Pay*, WALL ST. J., July 5, 2006, at A2 (quoting John Castellani, President of the Business Roundtable).

¹¹⁷The debate over Bebchuk's proposals has given considerable attention to the question whether shareholders *would* become adequately informed. *See, e.g.*, Bebchuk, *supra* note X, at 880-882; Bainbridge, *supra* note X, at 1745. I make a different argument: they *should have a duty* to become adequately informed.

¹¹⁸*See* Kahan & Rock, *supra* note X, at ____.

¹¹⁹Similar considerations have been used to argue against shareholder liability for a corporation's torts. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, 40-44 (1991).

them accountable for their decisions, since any adverse effects of their decision will not be felt until many of the outstanding shares will have changed hands. It also reduces the likelihood that the shareholders will be making informed decisions appropriate to the circumstances, and it removes the board's ability to act quickly with respect to those business matters the shareholders have chosen to govern. Bebchuk's proposal is troubling because it would give shareholders power without subjecting them to a concomitant duty and would thereby create an unaccountable power-holder, something previously unknown to fiduciary law.¹²⁰

V. Shareholder Activism Part II

However interesting they may be, Bebchuk's proposals are merely proposals, and they are unlikely to become law anytime soon. To the extent institutional shareholders are in fact seeking to improve corporate governance, they are doing so through existing legal procedures, and dissenting shareholders are protected by the board's fiduciary duties. Other shareholders, primarily hedge funds, are seeking to participate in management by exerting direct moral control over the board, which raises questions about the fiduciary duties of the board members who may respond to that control. Examples of this trend appear in the business pages every day, and include such corporate icons as General Motors, Time Warner, and McDonald's.¹²¹ Because shareholders do not manage the corporation, these shareholders seek to control the board, using persuasion, threats, and public exhortation. Often they succeed in placing one or more directors

¹²⁰Moreover, one cannot argue that the shareholders are not subject to duties when exercising control because it is "their" property they are controlling – in other words, that they are the principal, not the agent, and they are merely seeking to control their agent, the board – for the reasons described in Part II above.

on the board. As discussed above, directors owe a duty to exercise independent judgment in the best interests of the corporation no matter who appointed them.¹²² When Kerkorian's hand-picked director on the GM board votes the way Kerkorian wants him to vote rather than exercising his own judgment, has the director violated a duty?¹²³ These shareholders are not engaging in battles about repealing poison pills or appointing an independent lead director, matters which at least arguably relate to the balance of power between shareholders and the board and are therefore legitimate shareholder concerns. These are battles about the way the company is being run, including how best to realize value for the shareholders and whether to realize that value in the short term (as some hedge funds and other investors would prefer) or long term (as management or long-time family owners may prefer).¹²⁴ In other words, these are decisions generally covered by the business judgment rule, as long as the board is reasonably informed and a majority of the board is disinterested, and the activist shareholders involved are seeking to treat the board as their agents – that is, subject to their control.

¹²¹For an excellent discussion of the phenomenon see Kahan & Rock *supra* note X.

¹²²*See supra* note X and accompanying text. *See also* Zahn v. Transamerica Corp., 162 F.2d 36, 45-46 (3rd Cir. 1947).

¹²³This example is hypothetical. Kerkorian's director, Jerome York, has expertise in the industry and may very well have been selected by Kerkorian because he valued York's own judgment. Other GM directors have expressed enthusiasm for York's presence. However, York's contract entitles him to 4% of any gains Kerkorian realizes on his GM stock, so York's interests – and loyalties – are clearly intended to be aligned with Kerkorian's. *See* Monica Langley, *Newest Director Shakes Up GM with Calls for Radical Change*, WALL ST. J., Mar. 20, 2006 at A1. *See also* Paul Ingrassia, *Kerkorian Motors*, WALL ST. J., July 5, 2006, at A24 (describing York as Kerkorian's "advisor"); Holman W. Jenkins, Jr., *Who's Running GM?*, WALL ST. J., July 5, 2006, at A25 (treating Kerkorian as the motivating force and noting York's agreement with him).

¹²⁴*See* Kahan & Rock, *supra* note X, at 46-50 (discussing possible "short-termism" by hedge funds).

There are a number of questions one might ask about this sort of shareholder activity. Is it un-American, violating the principles of corporate enterprise that helped make this nation great?¹²⁵ Is it a welcome check on the increasingly unresponsive management of public companies?¹²⁶ Is it a pointless waste of management time and attention because shareholders cannot possibly have the information, incentives, and expertise necessary to make better decisions than current management?¹²⁷ Does it contribute to the rise of the “shareholder primacy norm” and therefore to the kind of behavior that led to the millennial financial scandals?¹²⁸ These are all interesting questions that are beyond the scope of this Article. My focus here is two related issues: What duties are owed by the representative of that shareholder on the board? And does the activist investor risk liability when, as a shareholder, it interferes in management decisions?

As noted above, fiduciary duties arise from a person’s exercise of legal power over another’s person or property, but do not arise from moral control. The fiduciary with legal power over the corporation is the board; a shareholder does not have legal power over the corporate property, although it may have moral control over members of the board.

Shareholders, whether controlling or not, are not “principals” of the board and therefore have no

¹²⁵See Bainbridge, *supra* note [UCLA] at 619-628.

¹²⁶See Kahan & Rock, *supra* note X, at 3; Bebchuk, *supra* note X, at 862-865. See also Gilson and Gordon, *supra* note X, at 785 (arguing that controlling shareholders can monitor management and serve to reduce agency problems between management and shareholders).

¹²⁷See Bainbridge, *supra* note [UCLA] at 624.

¹²⁸See Karmel, *supra* note X, at 7-9. See also Kahan & Rock, *supra* note X, at 46-50 (discussing short-termism).

legal control over the board. Therefore, they must act by influencing the board.¹²⁹ The first issue is therefore what duties are owed by a shareholder's designee on the board.

As discussed in Part II, above, the board owes its duties to the corporation and all its shareholders. This is true not only for the board as a whole, but also for any single board member, including those designated by minority shareholders. One might argue that it is acceptable for such designees to represent their shareholders' interests because, as minority board members, they cannot do any harm and because they may do some good by presenting a different perspective that is less deferential to management. The latter argument has some merit, but it begs the question. The alternative perspective that the designee presents must be a perspective on what is best for the corporation or it will not add value to board decision-making. The former argument, that designees can be allowed to act as their shareholders direct because they pose no threat to the corporation, fails to recognize the process by which boards operate. Board members can act only as a group; a single board member has no authority to act for the corporation. Although most boards act by majority rule,¹³⁰ in practice boards generally operate by consensus.¹³¹ Thus, a single director on a board of more than two will be unable, legally, to cause the corporation to do anything. This merely restates the proposition that, as a legal matter, no director or group of directors can cause the corporation to do anything; only the full board can do that.

¹²⁹See Dalley, *supra* note X, at 207-211.

¹³⁰See DEL. GEN. CORP. L. § 141(b).

¹³¹See Strine, *supra* note X, at ____.

As a practical matter, however, some directors may exercise more moral control than others where, for example, the director is sufficiently persuasive and strong-willed and the rest of the board is malleable or deferential.¹³² In that case, the resulting board action will appear to have been – legally must have been – taken by the board as a whole, and it will be difficult to prove that a single director was the instigator of the decision.¹³³ Lone directors occasionally make their individual views known, but only when they are dissenting from actions taken by the board.¹³⁴ In other words, we will rarely know whether a designated director has exercised any

¹³²See Darian M. Ibrahim, *The Board as a Collective Body or a Collection of Individuals: Implications for Director Liability* (July 2006), Arizona Legal Studies Discussion Paper No. 06-25, available at <http://ssrn.com/abstract=918119> at 21, 24, 26 (discussing situations in which a single director is likely to influence the outcome of a decision). See also Paul Ingressia, *Kerkorian Motors*, WALL ST. J., July 5, 2006 at A24 (observing that if Carlos Ghosn, automotive management genius, were on the GM board he would have “enormous influence”). The fact that boards have responded to the demands of activist investors suggests that a shareholder-designee on a board, when backed by a noisy investor, may have considerable moral power. See Kahan and Rock, *supra* note X, at ___ (describing successful activism). Moreover, if shareholder-designees are generally unable to affect corporate affairs, one wonders why activist investors so frequently ask for board representation. Of course, board representation also gives a shareholder access to inside information which could be used in managing the shareholder’s investments (if it were not illegal to do so).

¹³³There is therefore unlikely to be much litigation about the fiduciary duties of a single director representing a minority (although noisy) shareholder. The question is not merely academic, however. Directors need to know what they are supposed to do, even if they are unlikely to be sued for not doing it. Cf. Eisenberg, *supra* note X, at 26 (noting that the duty of good faith is important despite the fact that its breach does not create liability).

¹³⁴In 2004, the SEC adopted rules to require that issuers disclose the fact that a director has resigned because of a dispute with the board or management and publish any correspondence between the departing director and the issuer. See *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*, Securities Act Rel. No. 8400, _____, 2004, FED. SEC. L. REP. (CCH) [2003-2004 Transfer Binder] ¶87,158 at 89,508. Describing the operation of the rule, former Chairman Harvey Pitt noted that part of its value was that it provided individual directors with “leverage,” presumably to be used to pressure boards to do the right thing. See Phyllis Plitch, *New SEC Rules Show Underbelly of Corporations*, WALL ST. J., Oct. 12, 2005, at B4A.

real control in any given decision, and in most cases it will be the board as a whole that will be judged.¹³⁵ There are cases, however, where the influence of a single director or small group of directors not only causes change, but is known publicly to have done so.¹³⁶ This is especially likely to occur when a director has a separate agenda.¹³⁷

If shareholder's designees owe duties to the corporation and the shareholders as a whole,¹³⁸ what do those duties entail? The usual standard of care is generally stated to be that of the ordinary prudent person in the same or similar circumstances.¹³⁹ The operation of the business judgment rule protects a decision if it is made by an independent, informed board acting in what it believes in good faith to be the best interests of the corporation.¹⁴⁰ A director who merely rubber-stamps the decision of management has failed in her duty of care because she has not exercised her own independent, informed judgment.¹⁴¹ A director that serves only as a shareholder's mouthpiece has similarly failed to exercise her own independent, informed judgment and therefore has breached her fiduciary duty.

¹³⁵See Ibrahim, *supra* note X, at 8-9.

¹³⁶See *id.* at 26. See also Phred Dvorak and Jaclyne Badal, *Relative Problems*, WALL ST. J., July 24, 2006, at B1 (describing influence of members of founding families on company management). Cf. Siegman v. Tri-Star Pictures, Inc., 1989 WL 48746 at *3 (Del. Ch.) (refusing to infer control where shareholder had four of ten seats on board and power to veto transaction).

¹³⁷See Ibrahim, *supra* note X, at 21, 24, 26.

¹³⁸See *supra* notes X and accompanying text. See also, Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 DEL. J. CORP. L. 515, 555-558 (2001).

¹³⁹See e.g., AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE §401(a) (1994).

¹⁴⁰See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)

The next question is, which fiduciary duty is implicated when a director-designee does the shareholder's bidding without exercising independent judgment?¹⁴² In Delaware, a breach of the duty of care generally involves a failure to become reasonably informed¹⁴³ or gross negligence generally.¹⁴⁴ A director who does her shareholder's bidding without becoming fully informed probably violates that duty.¹⁴⁵ If she becomes fully informed, perhaps out of curiosity, but fails to exercise her independent judgment in the best interests of the corporation, she will not have breached her duty of care but may have breached either her duty of loyalty or her duty of good faith, or perhaps both. The Delaware Supreme Court has recently stated that "intentional dereliction of duty, a conscious disregard for one's responsibilities" constitutes a breach of the duty of good faith.¹⁴⁶ "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the

¹⁴¹See *In re Walt Disney Deriv. Litig.*, 2005 Del Ch. LEXIS 113 at *191 n.487, *quoted in* Eisenberg, *supra* note X, at 28-29.

¹⁴²See *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000); *Zahn v. Transamerica Corp.*, 162 F.2d 36, 46 (3rd Cir. 1947). Lest one think that all shareholder designees are in fact noble and independent-minded people who will not be influenced by the shareholder who nominated them, I note that when the Tribune Company board voted on its stock buyback, all seven independent directors and the CEO voted in favor, while the three directors appointed by the Chandler family (one of whom was Mr. Chandler) voted no. See Dennis K. Berman & Sarah Ellison, *Tribune Buyback Draws Opposition from Chandlers*, WALL ST. J., June 7, 2006, at A1. That seems remarkably coincidental.

¹⁴³See *In re Walt Disney Co. Deriv. Litig.*, ___ A.2d ___, 2006 WL 1562466 (Del. 2006) at *22.

¹⁴⁴See *id.* at *25.

¹⁴⁵See *Levco Alternative Fund Ltd. v. The Reader's Digest Ass'n., Inc.*, 2002 WL 31835461 at *3 (Del.).

¹⁴⁶*In re Walt Disney Deriv. Litig.*, 2006 WL 1562466 at *26.

corporation”¹⁴⁷ A director’s following the instructions of a shareholder, rather than exercising her own judgment about what is in the best interests of the corporation and all its shareholders, would appear to fall squarely within this definition of bad faith.¹⁴⁸ Incumbent directors have in fact used the prospect of such misplaced loyalty to fight shareholder nominees, arguing that they will not “think independently and vote their own conscience” or act as “independent voices accountable to all shareholders.”¹⁴⁹

The question whether such a director also violates her duty of loyalty is more difficult. Loyalty entails two concepts that are essentially reverse images of each other: interest and independence. An interested director is not independent; neither is a director who is “dominated and controlled” by an interested person.¹⁵⁰ A director is dominated and controlled when she is “beholden” to an interested person and “so under [that person’s] influence that [her] discretion would be sterilized.”¹⁵¹ Merely owing one’s position as a director to another does not make one beholden to that person,¹⁵² but more substantial financial ties, such as a situation in which the

¹⁴⁷*Id.* at *27.

¹⁴⁸This might not apply when the activist shareholder is herself sitting on the board, because she presumably made her investment, or decided to become active, out of a belief that her views constituted the best interests of the corporation, at least in some sense. *See* Kahan and Rock, *supra* note X, at ____.

¹⁴⁹*See* Heinz Questions Peltz/Trian Director Slate, Dow Jones Newswires, July 17, 2006; UPDATE: Heinz Sharpens Criticism of Peltz Board Nominees, Dow Jones Newswires, July 17, 2006. *See also* Aaron O. Patrick, *Aegis Holders are Advised to Oppose Bollore’s Moves*, Wall Street Journal Online, June 6, 2006.

¹⁵⁰*See* Brehm v. Eisner, 746 A.2d 244, 257 (Del. 2000).

¹⁵¹*Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

¹⁵²*See* Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 175, 177 (Del. Ch. 2005).

director's full-time employment was within another's control, might.¹⁵³ However, the fact that a director is dominated and controlled by another is only relevant if the other person is herself "interested".

"Interest" is usually defined as a financial interest not shared by other shareholders.¹⁵⁴ Broadly speaking, however, a conflict of interest can arise from any circumstance that impairs the director's ability to make a decision "based on the corporate merits of the subject before the board rather than extraneous considerations or influences."¹⁵⁵ Thus, while a director-designee may not meet the usual definition of interest in a transaction not directly involving the designating shareholder, she probably is not independent either.¹⁵⁶ Moreover, in many cases the interests of the activist shareholder and those of all the shareholders as a group may diverge.¹⁵⁷ Whether the shareholder's divergent interest is sufficient to taint her designee on the board will depend on the seriousness of the conflict. In many cases, the activist's interest will be different from but not directly conflicting with the interests of the rest of the shareholders. In that case, the director will not be interested even if she is dominated and controlled by the shareholder. She will not be independent, but mere lack of independence probably does not constitute a

¹⁵³ See *id.* at 177.

¹⁵⁴ See Eisenberg, *supra* note X, at 27-28.

¹⁵⁵ Aronson, 473 A.2d at 816.

¹⁵⁶ See *In re Emerging Comms., Inc. S'holder Litig.*, 2004 WL 1305745 at *39 & nn. 183-184 (Del. Ch.).

¹⁵⁷ See Kahan and Rock, *supra* note X, at ____; Jason Singer, *In Twist for Private Buyouts, Some Shareholders Fight Back*, WALL ST. J., Aug. 18, 2006, at A1; Jesse Eisinger, *Long & Short: Minority Shareholders in Sears Canada Win This Round of Ackman vs. Lampert*, WALL ST. J., Aug. 16, 2006, at C1.

breach of the duty of loyalty where a director is not interested.¹⁵⁸ In sum, the director-designee, if acting as a mouthpiece for her shareholder, probably violates her duties of care¹⁵⁹ and good faith.¹⁶⁰ A similar analysis would apply where any director is seeking to protect any interest other than that of the corporation writ large.¹⁶¹

This analysis suggests that there are a lot of breaches of the fiduciary duty of good faith occurring across corporate America. Every time a director does what someone else suggests without exercising independent judgment she breaches her duty. When directors act without independent judgment out of laziness, spinelessness, or psychological or structural “bias”¹⁶², they may breach their duties of care if they are grossly negligent. However, they are usually not liable for that breach because of the business judgment rule. But when they act without independent thought out of loyalty to another, they violate the duty of good faith and they are not protected by the business judgment rule. Of course, they will not actually be liable for anything unless something bad can be shown to have occurred as a result of their breach. Activist investors have been successful in causing changes at a number of companies in the past few years.¹⁶³ If the board, including designated directors, acted out of loyalty to or fear of an activist

¹⁵⁸See Eisenberg, *supra* note X, at 58.

¹⁵⁹See *supra* notes X and accompanying text.

¹⁶⁰See Eisenberg, *supra* note X, at 57-61, 66-67.

¹⁶¹See *id.*

¹⁶²See *Oracle*, 824 A.2d at 938-943 (considering the subtle influences that social and professional connections can have on decision-making and the reasons therefor); *Aronson v. Lewis*, 473 A.2d 805, 815 n.8 (Del. 1984).

¹⁶³See Kahan and Rock, *supra* note X, at ____.

shareholder, or even simply because it was tired of listening to the whining of an activist investor, it has breached its duties and may, in an extreme case, face liability.¹⁶⁴

So how does this relate to the duty of shareholders? If a director violates a fiduciary duty because she acts out of loyalty to an individual shareholder and not to the company, the shareholder should be equally liable for complicity in the breach. This can be vicarious liability under agency principles or aiding and abetting liability. The latter treatment merely implicates the general principle that one who aids or instigates a breach of duty is also liable for the breach.¹⁶⁵ The former treatment, however, raises another interesting problem in corporate law. Case law states expressly that directors are *not* agents of the shareholders who elect them.¹⁶⁶ This rule would be better phrased as, “Directors had better not be agents of the shareholders who elect them, or they are in deep trouble.”¹⁶⁷ Agency requires that the agent be under the control of the principal. A director who is doing her job is not under the control of anyone – that is the essence of independent judgment. So, when a director acts out of loyalty to another, not only has she violated her fiduciary duty, she may have acted as an agent of the other person.¹⁶⁸ There is no reason to deny *automatically* the existence of an agency relationship, and therefore of vicarious liability, in that situation.

¹⁶⁴See Ibrahim, *supra* note X, at 22-25 (discussing potential liability where only one director breaches a duty of good faith).

¹⁶⁵See *In re General Motors (Hughes) S’holder Litig.*, 2005 WL 1089021 at *23 (Del. Ch. May 4, 2005); *Siegman v. Tri-Star Pictures, Inc.*, 1989 WL 48746 at *4.

¹⁶⁶See Dalley, *supra* note X, at 219.

¹⁶⁷See *id.*

¹⁶⁸See *Zahn v. Transamerica Corp.*, 162 F.2d at 46.

VI. Conclusion

In sum, a corporate act undertaken on behalf of a specific shareholder (any shareholder) that injures the other shareholders or the corporation itself entails a breach of fiduciary duty by the directors who so acted, and the instigating shareholder is also liable for that breach under basic agency principles. No “shareholder fiduciary duty” is implicated. Existing law, properly applied, not only addresses the problem of harmful corporate¹⁶⁹ acts, it also does so without doing violence to the principle that shareholders do not manage (and therefore do not owe duties to) the corporation. Suppose instead that we adopt the view that shareholders owe duties to the corporation and other shareholders. When is this duty implicated? When the noisy investor begins pressuring the board? When the investor votes? That is clearly within her rights as a shareholder. The only way an investor can cause harm is by controlling the board. So the law finds and punishes the breach when and where it happens – when the board members act disloyally.

This analysis is not new. What is new is the number of instances of directors of publicly traded corporations, hitherto not the subject of shareholder fiduciary duty analysis, making business decisions directed by individual shareholders. The duties of those directors, and the

¹⁶⁹If the act is not a corporate act, but is a shareholder act such as a shareholder selling her shares or voting for a director or in favor of a merger, no fiduciary duties apply at all, and the injured party, if there is one, is out of luck.

potential responsibility of the shareholders who appoint them, are therefore of heightened importance.