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ARTICLES

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Corporate law and scholarship generally assume that professional managers control public corporations, while shareholders play only a weak and passive role. As a result, corporate officers and directors are understood to be subject to extensive fiduciary duties, while shareholders traditionally have been thought to have far more limited obligations. Outside the contexts of controlling shareholders and closely held firms, many experts argue shareholders have no duties at all.

The most important trend in corporate governance today, however, is the move toward "shareholder democracy." Changes in financial markets, in business practice, and in corporate law have given minority shareholders in public companies greater power than they have ever enjoyed before. Activist investors, especially rapidly growing hedge funds, are using this new power to pressure managers into pursuing corporate transactions ranging from share

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repurchases, to special dividends, to the sale of assets or even the entire firm. In many cases these transactions uniquely benefit the activist while failing to benefit, or even harming, the firm and other shareholders.

This Article argues that greater shareholder power should be coupled with greater shareholder responsibility. In particular, it argues that the rules of fiduciary duty traditionally applied to officers and directors and, more rarely, to controlling shareholders should be applied to activist minority investors as well. This proposal may seem a radical expansion of fiduciary doctrine. Nonetheless, the foundations of an expanded shareholder duty have been laid in existing case law. Moreover, there is every reason to believe that newly empowered activist shareholders are vulnerable to the same forces of greed and self-interest widely understood to face corporate officers and directors. Corporate law can, and should, adapt to this reality.

INTRODUCTION

In the typical American public corporation, power is dispersed among three key groups: shareholders, the board of directors, and the company's executive officers, including its Chief Executive Officer (CEO). Each group has rights and privileges. Each also has duties and responsibilities.

Contemporary corporate case law and scholarship, however, pay far more attention to corporate officers' and directors' duties than to shareholders'. Officers and directors are understood to owe fiduciary duties that are broad and deep, constraining their every material business decision.[1] Shareholders are thought to have far more limited obligations. In fact, outside the narrow contexts of closely held companies and self-dealing by majority shareholders, many commentators assume shareholders have no duties at all.[2] Minority stockholders in public companies are often viewed as free agents, at liberty to try to influence corporate policy as they see fit—including trying to influence corporate policy in ways that favor their own interests over those of the corporation and other shareholders.

The risk that minority shareholders in public firms might use their power in self-serving ways has understandably attracted little attention for two reasons. First, until recently, minority shareholders have played a largely passive role in public companies. This passivity has been driven by both economic and legal forces. From an economic perspective, the cost of trying to influence corporate policy has typically outweighed the likely impact of such effort on the value of any single shareholder's interest, leaving dispersed shareholders in public companies "rationally apathetic."[3] From a legal perspective, traditional

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1. *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW 123-262 (1986) (describing at length duties of officers and directors). *See generally infra* notes 11-25 (describing broad fiduciary duties of executives and directors).

2. *See, e.g.*, JEFFREY D. BAUMAN ET AL. CORPORATIONS: LAW AND POLICY 36 (6th ed. 2007) ("Although directors owe fiduciary duties, shareholders generally do not."); CLARK, *supra* note 1, at 141 ("Directors, officers, and, in some situations, controlling shareholders owe . . . a fiduciary duty of loyalty."); 12B WILLIAM MEADE FLETCHER, THE FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5713 (rev. ed. 2000) ("A shareholder occupies a position and owes a duty radically different from a director. . . . [A] shareholder may vote with the view merely of his or her own self-interest. Ordinarily, unless the shareholder is a majority shareholder or active in the management of the corporation, he has no well-defined duties."); David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 537 (2006) ("American public shareholders are uniquely blessed by the freedom to do what they will . . . . [S]hareholders owe the corporation no legal duties."); Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Investors?*, 60 BUS. LAW. 1, 2 (2004) ("Shareholders do not generally owe any duties to one another or the corporation[] . . . ."). *See generally infra* notes 41-59 (describing how shareholder duties are conventionally viewed as limited to controlling shareholders, primarily in freeze-out and close corporation contexts).

3. *See infra* text accompanying notes 34-36.

corporate law rules have done little to overcome this hurdle.[4] The result has been that minority shareholders in public firms have been perceived as having far less power to set corporate policy than directors and officers have.

The second reason why the question of minority shareholders' duties has been largely overlooked is that, even when minority shareholders do try to take an active role in public companies, it has been generally believed that their primary goal is to improve the firm's overall economic performance—an interest that is closely aligned with both the interests of the firm and the interests of other shareholders. Shareholder activism, accordingly, has been assumed to be a beneficial influence.[5]

In this Article, we argue that both of the foregoing assumptions are becoming increasingly inaccurate. The economic and legal context in which American public corporations do business is changing swiftly in ways that create a pressing need to reexamine conventional notions of shareholder duties. As a result of recent developments in financial markets, business practices, and corporate law, minority shareholders are finding it economically rational to try to influence corporate decision-making. The long-standing assumption that public company shareholders lack the ability or incentive to engage in activism is no longer accurate. Meanwhile, even as shareholders are becoming more powerful, their interests are becoming more heterogeneous. Increasingly, the economic interests of one shareholder or shareholder group conflict with the economic interests of others. The result is that activist shareholders are using their growing influence not to improve overall firm performance, as has generally been assumed, but to profit at other shareholders' expense.

Consider the following three scenarios, each of which involves an activist shareholder seeking to advance its own interests to the exclusion or detriment of other shareholders' interests:

1. A large, publicly held corporation owns and runs a national chain of grocery stores. The chain becomes embroiled in bitter contract negotiations with its employees' union over proposed cuts in employee pay and benefits. The union publicly blames the dispute on the hard-line negotiating stance of the grocery chain's CEO. The employees' union runs a pension fund for its members. The union pension fund portfolio includes significant holdings of common stock in the grocery store chain. Using its status as a shareholder in the company, the pension fund mounts an aggressive proxy campaign to remove the company's CEO.

2. A hedge fund owns a large block of common stock in a troubled biotech company. To raise the stock's share price, the hedge fund urges the biotech company's management to put the company up for sale, but finding a buyer willing to pay a premium for the company's shares proves difficult. Finally, a large health sciences corporation expresses interest in acquiring the biotech

4. *See infra* text accompanying notes 64-67.

5. *See infra* text accompanying notes 37-39.

firm. Industry analysts voice doubts about the acquisition, believing the price too high. At this point, the hedge fund buys 10% of the common stock of the possible acquirer. The hedge fund keeps formal title to the stock, along with its legal status as a shareholder in the acquirer and the right to vote 10% of the acquirer's common shares. However, the hedge fund enters into a derivatives contract with an investment bank to hedge away its economic interest in the acquiring corporation. If the acquirer's stock price declines, the investment bank, and not the hedge fund, will bear the loss. The hedge fund then approaches the acquirer's board and informs the board that if any of its members oppose buying the biotech company, the hedge fund will use its shareholder status to mount a proxy battle to remove that director from the board.

3. A small environmental services company raises $10 million in new capital from a private investment partnership. In return, the investment partnership gets 45% of the environmental services company's common stock and preferred stock with a $15 million liquidation preference (a right to receive liquidation proceeds that is senior to that of common stockholders). The liquidation preference can be triggered by a sale of all the company's assets approved by a majority of the board and a majority of the common shares. Just a few weeks later, the investment partnership announces it has found a third-party buyer willing to pay $15 million for all the environmental services company's assets. Because the asset sale would trigger the $15 million preferred stock liquidation preference, the company's common stock would become worthless. Thanks to its preferred stock interest, however, the investment partnership would make a quick 50% profit on its initial $10 million investment. The board of directors of the environmental services company, a majority of whom are investors in the investment partnership, quickly approves the asset sale. Because the investment partnership already owns 45% of the company's common shares, the sale will go forward if 5% or more of the firm's other common shares are voted in favor of the deal. The investment partnership approaches several other shareholders of the environmental services company who collectively own 6% of the company's common stock and offers them the opportunity to participate in unrelated business deals on highly favorable terms if they agree to vote their shares in favor of the asset sale. The asset acquisition is approved.

These scenarios are stylized variations of actual cases reported in judicial opinions or the business press.[6] They illustrate how minority shareholders in public companies can and do use their growing influence to push for corporate actions that serve their personal economic interests. It is unclear whether and to what extent the traditional rules of shareholder fiduciary duty reach such self-

6. *See infra* text accompanying notes 118-21 (describing CalPERS proxy campaign at Safeway), 127-30 (describing Perry Capital's actions with regard to the proposed Mylan Laboratories-King Pharamaceuticals merger), 135-39 (discussing DiLillo v. Ustman Techs., Inc., No. B148198, 2001 Cal. App. Unpub. LEXIS 1527 (Cal. Ct. App. Nov. 19, 2001)).

serving behavior. This lack of clarity has encouraged activist shareholders, especially hedge funds, to "push the envelope" in employing activist tactics to pressure corporate officers and boards into pursuing business policies that uniquely benefit the activist, while failing to help—or even harming—the firm and its other shareholders.

We believe that fiduciary duty doctrine can and should be interpreted in a way that takes into account changes in the corporate landscape and reaches such opportunistic behavior. Indeed, we believe that the law of fiduciary duty is uniquely suited to address the growing problem that opportunistic shareholder activism poses for corporate governance. To this end, we propose concrete recommendations for furthering this doctrinal evolution.

Our approach has two advantages as a strategy for dealing with self-serving shareholder activists. First, it brings existing fiduciary duty doctrine into line with the changing reality of how and why shareholders assert power in the corporate governance arena. As a result, it offers a broad, flexible, and preemptive solution to the problem of shareholder overreaching. This seems likely to be a far more effective approach than the sorts of *ad hoc*, after-the-fact responses to particular forms of abusive shareholder behavior that regulators have adopted in the past and that prominent corporate law scholars continue to propose today.[7]

Second, we believe our reinterpretation of shareholder fiduciary duty can lend much-needed support to the controversial but increasingly influential normative claim that promoting "shareholder democracy" is a useful way to constrain managerial misbehavior.[8] In the wake of recent corporate scandals, firms and regulators have urged the adoption of a variety of changes in corporate law and practice designed to increase shareholders' power to pressure the directors of publicly held firms into adopting particular business policies, from requiring more independent directors, to de-staggering corporate boards, to requiring shareholder votes on CEO pay.[9] Academics and investor interest groups are calling for even more "shareholder empowerment."[10] Whether or not the modern trend of shifting corporate power toward shareholders and away from boards and executives will ultimately serve shareholders' own interests

7. *See infra* text accompanying notes 158-63.

8. Professor Lucian Bebchuck is the leading contemporary proponent of shareholder democracy. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) [hereinafter Bebchuk, *The Case for Increasing Shareholder Power*]; Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter Bebchuk, *The Myth of the Shareholder Franchise*].

9. *See, e.g.*, Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 8 (arguing for the adoption of a regime with more shareholder control). *See generally infra* text accompanying notes 99-107.

10. The issue of shareholder power has attracted such attention that it has been the subject of not one but two recent symposia in leading law reviews. *See Essays*, 93 VA. L. REV. 675 (2007) (containing six essays on the myth of the shareholder franchise); *Responses to Increasing Shareholder Power*, 119 HARV. L. REV. 1735 (2006).

depends critically on how individual shareholders and shareholder groups actually exercise their growing influence. By limiting their ability to use it in opportunistic and self-serving ways, we hope to encourage a version of shareholder democracy that promotes, rather than destroys, shareholder value.

Part I begins by briefly surveying contemporary corporate law rules of fiduciary duty, focusing especially on the duty of loyalty. The duty of loyalty is usually applied to corporate officers and directors, where it is interpreted as a presumption that any "interested" transaction—that is, any corporate transaction that provides a material personal economic benefit to the officer or director—is a potential basis for personal liability unless the officer or director can demonstrate to the court's satisfaction that the transaction, though tainted by self-interest, was nevertheless intrinsically fair to the corporation. In some cases, courts impose a similar fiduciary duty of loyalty on shareholders. However, courts impose those duties only on "controlling" shareholders, meaning shareholders who enjoy the ability to control the company's board of directors. Moreover, the vast majority of cases in which shareholder fiduciary duties have been applied involve either freeze-out transactions or closely held corporations. This pattern of very limited application of shareholder fiduciary duties is grounded in the assumptions that (1) minority shareholders in public firms are relatively powerless, and (2) minority shareholders share a strong common interest in improving corporate performance that reduces the risk of opportunistic behavior.

Part II discusses why both assumptions are becoming increasingly inaccurate. In recent decades, a number of important developments—including increased institutional investing, changes in federal proxy law, the creation of shareholder advisory services, the rise of activist hedge funds, and financial innovations that can magnify activists' voting power—have worked together to significantly shift the balance of power in public firms away from executives and boards and toward activist shareholders. The trend seems likely only to continue as would-be reformers push to increase shareholder power further. Meanwhile, as shareholders are becoming more powerful, they are also becoming more heterogeneous. Activist shareholders can have serious conflicts of interest with other shareholders arising from their other relationships with the firm, from their investments in derivatives or securities issued by other corporations, from their investments in other parts of the firm's capital structure, and from their short-term investment focus. Taken together, the two trends of shareholders becoming both more powerful and more divided point to an inevitable increase in the risk of shareholder opportunism.

Part III explores how American corporate law can address this increased risk through the relatively straightforward mechanism of applying corporate fiduciary duties to shareholders more broadly. In particular, activist shareholder overreaching can be deterred by interpreting loyalty duties to apply not only to controlling shareholders, who can dictate board decisions in all matters, but also to activist minorities who succeed in influencing management with respect

to a single transaction or business decision. Moreover, shareholder fiduciary duties should be applied not only in the traditional contexts of freeze-outs and closely held corporations but also in any factual situation where a shareholder reaps a unique personal economic benefit to the detriment or exclusion of other shareholders. On first inspection, our proposal may seem a radical expansion of existing law. We show, however, that the scope of these admittedly expanded shareholder duties can be kept within reasonable bounds by allowing shareholders, like officers and directors, to rely on standard loyalty defenses, including the defense that their conflict of interest was not material or that the challenged transaction was intrinsically fair.

Part IV addresses several potential objections to our proposal, including the objections that it will foster excessive litigation, that it will chill beneficial shareholder activism, and that fiduciary duties for activist shareholders are unnecessary, as any attempt by activists to use their influence for personal gain will be checked by the principle of majority rule. Part IV demonstrates that none of these objections is persuasive.

We conclude by pointing out there is no reason to assume that activist shareholders are somehow impervious to the same temptations of greed and self-interest that are widely understood to face corporate officers and directors. Our proposed reinterpretation of shareholder fiduciary duties recognizes this reality.

I. FOUNDATIONS OF SHAREHOLDER FIDUCIARY DUTIES

A. *Corporate Fiduciary Duties*

One of the most basic concepts in corporate law is that of fiduciary duties. With modest variations, these duties fall into two broad categories: the duty of loyalty and the duty of care.[11] Both duties are usually discussed in the public company context as they apply to "managers" (that is, executive officers and corporate directors). We thus begin our discussion by surveying briefly how corporate fiduciary duties of loyalty and care are interpreted in this context.

In theory, corporate officers and directors owe the corporation and its shareholders a duty of care, meaning a duty not to act negligently. In practice, this duty has been modified (some might say extinguished) by the doctrine known as the "business judgment rule." The business judgment rule is usually described as a legal presumption that the directors and officers of the corporation have exercised due care by acting on an informed basis, in good faith, and in the honest belief that their actions are in the best interests of the corporation.[12] Unless a plaintiff can produce persuasive evidence rebutting one

11. *See generally* CLARK, *supra* note 1, at 126-36, 141-57 (discussing duties).

12. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). *See generally* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and*

of these three elements, corporate directors and officers are effectively insulated from liability for breach of the duty of care.

It is very difficult for a plaintiff to establish, as a practical matter, that corporate managers who made even a token effort to perform their jobs were not "informed," especially in the face of case law suggesting that only a showing of gross negligence will make the case.[13] It is also difficult for a plaintiff to demonstrate convincingly that an executive or director who does not have a conflict of interest (which would raise loyalty issues) was nevertheless acting in "bad faith" or on the belief her decision would harm the corporation. For these and other reasons,[14] the duty of care offers notoriously weak protection against negligence by corporate officers and directors.

In contrast, the fiduciary duty of loyalty has teeth and provides the principal legal constraint against managerial misbehavior—and, we argue below in Part III.B, against shareholder misbehavior as well. As a result, it is the duty of loyalty that receives the lion's share of our attention. Unlike the duty of care, which applies even to well-intentioned decisions, the duty of loyalty focuses on motive.[15] Theorists have conceived of the nature of the duty in various ways, sometimes sounding in trust theory and other times in agency theory.[16] At its core, however, the duty of loyalty requires a corporate fiduciary (in this case, an officer or director) to act only in the best interests of the fiduciary's beneficiary (in this case, the firm and its shareholders).[17] In other words, the duty of loyalty asks managers to place the interests of the corporation and its shareholders above their own interests.

Given the human instinct for pursuing self-interest,[18] this is a tall order. How does loyalty doctrine attempt to fill it? Most obviously, corporate law discourages loyalty violations by adopting a modified version of the strict prophylactic prohibition, drawn from trust and agency law, known as the "exclusive benefit" rule. The exclusive benefit rule rests on the notion that if we want to ensure fiduciaries act only in their beneficiaries' interests, the first thing we must do is eliminate any possibility that fiduciaries can act in their own interests. This can be done by flatly forbidding fiduciaries from using their power over a beneficiary's assets in any way that might bring a fiduciary personal gain. Even though such "self-dealing" transactions might in some

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the Business Judgment Rule, 96 NW. U. L. REV. 675 (2002) (discussing the business judgment rule).

13. *See* Stout, *supra* note 12, at 680 & n.19.

14. *See id.* at 680 & n.18. For example, indemnification, insurance, and exculpation reduce the risk to managers of personal liability for any breaches of the duty of care.

15. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

16. Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990).

17. *Id.*

18. *See, e.g.*, Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite* Homo Economicus *to Join Your Board)*, 28 DEL. J. CORP. L. 1, 9, 16-20 (2003) (discussing the role of self-interest in corporate theory and practice).

cases benefit both parties, they are strictly prohibited.

The justification for this traditional prohibition is twofold. First, absent such a strict rule, it is feared fiduciaries inevitably will be tempted to use their positions to benefit themselves at their beneficiaries' expense. Second, given the complex and ongoing nature of the fiduciary relationship, it is often not feasible to protect beneficiaries against this sort of opportunistic behavior through explicit contracts or careful monitoring.[19] Thus, the benefits of a strict prophylactic prohibition, according to the logic of the exclusive benefit rule, outweigh the costs.

Corporate law takes a much more relaxed view of the exclusive benefit principle than does the common law of trust and agency. In particular, it does not prohibit corporate fiduciaries from dealing with their firms or their shareholders. Rather, corporate law modifies the strict rule against self-dealing by allowing corporate officers and directors to use their corporate powers to pursue business transactions that benefit themselves as long as they are prepared to prove to a disinterested party—in particular, to a court—that the transaction, although self-interested, was nevertheless intrinsically "fair" to the corporation.[20] Thus, a corporate officer or director can be found liable for breach of the duty of loyalty only if (1) she uses her corporate office to promote a corporate transaction that provides her with material personal benefits *and* (2) the transaction is "unfair." It is not fiduciary self-dealing alone that is improper. Instead, it is *unfair* fiduciary self-dealing that is improper.

Procedurally, a plaintiff who seeks to hold a corporate officer or director liable for breach of the duty of loyalty has the initial burden of alleging that the contested transaction was tainted by self-interest. To do this, courts have generally held the plaintiff must show the officer or director stood to reap a material economic benefit from the transaction.[21] Once the plaintiff has shown the possibility of self-interest, the burden shifts to the defendant to demonstrate the intrinsic fairness of the transaction to the company.[22] In analyzing intrinsic fairness, courts consider both the terms of the transaction ("fair price") and the fairness of the bargaining process leading up to it ("fair dealing").[23]

Here again, corporate law adds some important bells and whistles to traditional fiduciary duty doctrine. For example, the Delaware corporate code provides for two procedures that courts have deemed are so significant that, if officers and directors follow them properly, they shift the legal burden of demonstrating unfairness back to the plaintiff. In particular, a corporate officer or director can shift the burden of demonstrating unfairness by showing that the

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19. CLARK, *supra* note 1, at 141.

20. Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991), *quoted in* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1170 (Del. 1995).

21. Weinberger v. UOP, Inc., 457 A.2d 701, 703-04 (Del. 1983); DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE 283-88 (1998).

22. *See Weinberger*, 457 A.2d at 703.

23. *See id.* at 711.

transaction in question, although admittedly self-interested, was nevertheless approved after full disclosure by either (1) a majority of the company's disinterested directors or (2) by a majority of the company's disinterested shareholders. If either showing is made, the burden of demonstrating unfairness reverts to the plaintiff.[24]

While corporate law's loyalty rules are more flexible than their traditional counterparts under the laws of trust and agency,[25] they share the same prophylactic character. Corporate officers and directors can engage in self-interested transactions, but only subject to the judicial test of fairness. And while defendants can shift the burden of showing unfairness onto the plaintiff by demonstrating that the conflicted transaction was disclosed to and approved by either the corporation's disinterested directors or its disinterested shareholders, fairness remains the judicial touchstone in corporate law loyalty cases.

B. *Fiduciary Duties of Shareholders*

As noted above, fiduciary duties are usually applied to officers and directors. In some cases, however, courts impose fiduciary duties of loyalty on certain types of shareholders as well. When they do, the analysis tends to follow the application of loyalty duties in officer and director cases. In particular, courts have held that majority shareholders, like corporate officers and directors, owe a fiduciary duty of loyalty to minority shareholders that precludes them from using their positions as controlling shareholders to extract material economic benefits from the firm at the minority's expense.[26] As articulated by the California Supreme Court in the case of *Jones v. H.F.*

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24. *See* DEL. CODE ANN. tit. 8, § 144 (2005). When there is disinterested director or disinterested shareholder approval, most case law suggests that the defendant may not be immunized from a loyalty claim. Instead, the burden of proving the substantive unfairness of the transaction may simply shift back to the plaintiff. *See Weinberger*, 457 A.2d at 703; *In re* Wheelabrator Techs. Inc. S'holders Litig., 663 A.2d 1194 (Del. Ch. 1995). Nevertheless, there is some authority suggesting that, in certain circumstances, disinterested director or disinterested shareholder approval can effectively insulate a defendant from loyalty claims. *See* Lewis v. Vogelstein, 699 A.2d 327, 334 (Del. Ch. 1997) (discussing the question).

25. Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 599 n.12 (1977).

26. *See* Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471-72 (Cal. 1969); Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

In some circumstances, shareholders have been held to have a duty of care as well. In particular, a few cases have held that a controlling shareholder may breach its duty of care if it knowingly sells control of the corporations to a "looter" (that is, a controlling shareholder that plans to breach its duty of loyalty and expropriate corporate assets for itself). Swinney v. Keebler Co., 480 F.2d 573, 577 (4th Cir. 1973); Abraham v. Emerson Radio Corp., 901 A.2d 751, 762 (Del. Ch. 2006).

Ahmanson & Co.,[27] "Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately . . . ."[28]

Consider, for example, an individual who owns 51% of a company's common stock and so can dictate who sits on the company's board of directors. Such a majority shareholder might be tempted to use his power over the board to push through a corporate transaction that provides a unique profit opportunity for him while harming minority shareholders. The classic example is a "freeze-out" merger in which the minority shareholders are forced to sell their shares, at an unfairly low price, to an entity that is wholly owned by the controlling shareholder. As in the case of interested transactions by corporate officers and directors, courts deem freeze-outs orchestrated by controlling shareholders to be interested transactions and potential violations of controlling shareholders' duties of loyalty. As in the case of corporate officers and directors, such interested transactions are not utterly prohibited. A controlling shareholder can escape liability by proving, to the court's satisfaction, that while the transaction was tainted by a conflict of interest, it was nevertheless intrinsically fair to the firm and other shareholders.

Also, as in the case of officers and directors, courts assessing the fairness of controlling shareholders' transactions initially put the burden on the controlling shareholder to establish the intrinsic fairness of the deal to the corporation and its minority investors. In addition, the concept of intrinsic fairness similarly encompasses both substantively fair terms and fair bargaining procedures.[29] Thus, to prove that an interested transaction was nevertheless entirely fair to the corporation and its minority shareholders, a controlling shareholder must prove to the court's satisfaction that the transaction took place at a "fair price" and that it was accomplished through "fair dealing."[30]

Finally, as with officers and directors, courts have found that some bargaining procedures contribute so substantially to a finding of intrinsic fairness that, if those procedures are followed, the court will shift the burden back to the plaintiff to prove that the transaction, despite the fairness of the procedures surrounding it, involved substantively unfair terms. This is particularly clear in controlling shareholder cases where a suspect transaction, after full disclosure, was approved by "a majority of the minority," meaning a majority of the minority shareholders who did not have a conflict of interest.

The effect of approval by a majority of the company's "disinterested" *directors* is more uncertain, as some courts have shown a justifiable reluctance

27. 460 P.2d 464 (Cal. 1969).

28. *Id.* at 471.

29. *Kahn*, 638 A.2d at 1115; *Weinberger*, 457 A.2d 711.

30. *Weinberger*, 457 A.2d at 711 (holding that fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to directors and how the approvals of the directors and shareholders were obtained").

to assume that any director can truly be "independent" of a controlling shareholder with the power to remove her from the board. Nevertheless, certain Delaware case law suggests that if a transaction involving a controlling shareholder is approved by a special board committee comprised of disinterested directors with "real bargaining power" that deals with the majority shareholder "at arms length," this shifts the burden of showing unfairness back to the plaintiff.[31]

C. *Limits of Shareholder Duties*

It thus appears that, at least in certain cases, courts subject shareholders to loyalty duties similar in nature to the loyalty duties imposed on corporate officers and directors. Nevertheless, most contemporary discussions of fiduciary duty in public corporations continue to orbit around officers and directors. Modern corporate casebooks, for example, typically emphasize that shareholders have "rights," while officers and directors have "duties" and "obligations."[32] Similarly, while the Delaware General Corporation Law contains a specific provision addressing director and officer liability for conflict of interest transactions, it includes no provision directly addressing shareholder liability for breach of fiduciary duty, instead leaving the question entirely to case law.[33]

Why do shareholders' duties receive so little attention? The puzzle can be explained in part by the fact that shareholders in public corporations historically have been passive investors, not active participants in corporate governance. This passivity stemmed not only from the "public good" nature of shareholder activism (a minority shareholder who seeks to improve corporate performance must bear all the costs of the activism while sharing any resulting benefits with all the firm's other shareholders)[34] but also from traditional corporate law rules of proxy voting which made it difficult and expensive for

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31. *Id.* at 709 n.7.

32. *See, e.g.*, JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 183, 327 (2d ed. 2003) (containing chapters titled "Directors' and Officers' Duties of Care and Loyalty" and "Rights and Powers of Shareholders: Inspection rights, Voting, and Proxies"); FOUNDATIONS OF CORPORATE LAW 148, 187, 258 (Roberta Romano ed., 1993) (containing chapters titled "Boards of Directors and Fiduciary Duties," "Management's Fiduciary Duty and Takeover Defenses," and "Shareholder Voting Rights and the Exercise of Voice").

33. *See supra* note 24.

34. *See* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 76 (1932) ("[T]he normal apathy of the small stockholder is such that he will either fail to return his proxy vote, or will sign on the dotted line, returning his proxy to the [management] of the corporation."). *See generally* RUSSELL HARDIN, COLLECTIVE ACTION (1982); MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1971). The resulting disincentive to act is compounded by the free-rider problem that any one shareholder may decide to save itself the cost of acting in the belief that another shareholder will do so. *See* CLARK, *supra* note 1, at 392-93 (discussing the free-rider problem).

shareholders to attempt to exercise meaningful corporate power.[35] To the extent that shareholders in public corporations were unable, as a practical matter, to influence corporate policy, one can understand why the question of shareholder fiduciary duties has been neglected. As one commentator has put it, "There is no need for concern about the oppressive propensities of persons who lack the power of implementation."[36]

A second reason why shareholder duties have not attracted much attention is the common belief that, even in the rare case when a minority shareholder tries to take an active role in corporate decision-making, that activism benefits both the corporation and other shareholders.[37] According to this view, minority shareholders want to make the corporation as profitable as possible in order to maximize the value of their shares. To the extent they accomplish this objective, they serve not only their own interests but those of the other shareholders as well. In other words, shareholder interests are "similar if not identical,"[38] so that for the vast majority of business decisions the self-interest of any single shareholder coincides with the interests of all shareholders.[39] This theory of uniform shareholder interest independently renders fiduciary limits on shareholder action unnecessary.

Taken together, the assumption that shareholders in public firms are mostly passive, and the belief that shareholders have common interests, have led many observers to conclude that shareholders, unlike corporate officers or directors, are not *generally* bound by fiduciary duties.[40] Instead, shareholder duties are thought to arise only for limited types of shareholders, and only in limited types of circumstances.

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35. In particular, where corporate law allows incumbent directors to use corporate funds to solicit proxies for their own re-election, dissident shareholders must generally use their own funds to wage a proxy battle to oust incumbents. *See* BERLE & MEANS, *supra* note 34, at 76 ("[T]he cost of mobilizing the votes of tens or hundreds of thousands of stockholdings by circularizing them and perhaps conducting a publicity campaign, must be such as to prevent any but the most wealthy from seeking this method of seizing control [over the corporation] . . . . This is especially the case where the existing control [group] can charge to the corporation the costs of its fight to maintain its position, while the outsider must conduct a fights at his own private expense."). *See generally infra* text accompanying notes 67, 74-78 (describing how proxy rules disfavor dissidents). Other legal rules can also discourage shareholder activism. *See generally* Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 522 (1990).

36. J.A.C. Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L.J. 921, 933.

37. *See* Hetherington, *supra* note 36, at 934; Earl Sneed, *The Stockholder May Vote As He Pleases: Theory and Fact*, 22 U. PITT. L. REV. 23, 24 (1960).

38. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983). *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006) (arguing that shareholder power advocates "regard shareholders as a monolith with a single, overriding objective—maximizing shareholder value").

39. Hetherington, *supra* note 36, at 934.

40. *See, e.g.*, sources cited *supra* notes 2, 32.

Existing law on shareholder fiduciary duties can be interpreted as limiting shareholder duties in at least two important ways. First, cases often seem to suggest that only "controlling" shareholders are subject to the duty of loyalty, while "non-controlling" shareholders may vote as they please without objection that their motives are for personal gain.[41] Second, courts have tended to find even controlling shareholders subject to fiduciary duties primarily in two limited business situations: corporate "freeze-outs" and closely held corporations.

1. *Controlling shareholders*

Let us begin with the idea that shareholder duties apply only to "controlling" shareholders. Contemporary discussions often implicitly assume that the only shareholders who owe any fiduciary duties are "controlling" shareholders; that is, shareholders in a position to dictate to the corporation's business decisions and particularly the membership of its board of directors.[42] Indeed, the degree to which a shareholder controls the board has become the judicial touchstone of shareholder fiduciary duty.

In particular, because shareholders generally elect and remove directors by majority vote,[43] a shareholder who owns more than 50% of the company's outstanding shares has become the archetypal "controlling" shareholder.[44] Shareholders who own less than a majority are not, without more, controlling shareholders. They can be deemed controlling only if a court finds they exert "actual control" over the corporation.[45] This idea is reflected in a number of cases where courts have rejected the argument that a shareholder of a public company who does not hold more than 50% of the firm's shares should automatically be subject to fiduciary duties. Instead, when a shareholder has a less than majority stake, courts tend to engage in cautious, detailed factual analysis of whether that particular shareholder, individually or together with associates, owns enough shares to give the shareholder clear voting power to replace the board of directors.

An illustrative case is *In re Cysive, Inc. Shareholders Litigation*,[46] in which Nelson Carbonell owned approximately 35% of Cysive, Inc., a publicly traded company. When associates' holdings and options to purchase additional stock were taken into account, Carbonell controlled as much as 40% of

41. Sneed, *supra* note 37, at 23; *see, e.g.*, Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989); Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987); Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del. 1984); Weinstein Enterprises Inc. v. Orloff, 870 A.2d 499, 507 (Del. Ch. 2005).

42. *See* sources cited *supra* note 2.

43. DEL. CODE ANN. tit. 8, §§ 211(b), 141(k) (2005).

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

45. *Citron*, 569 A.2d 53; *Ivanhoe*, 535 A.2d 1334; *Weinstein*, 870 A.2d 499.

46. 836 A.2d 531 (Del. 2003).

Cysive's voting equity. In deciding whether this made Carbonell the "controlling" shareholder of Cysive, the Delaware Chancellor focused on Carbonell's ability, should he became disenchanted with Cysive's directors, to elect a new board "without having to attract much, if any, support from public stockholders."[47] The Chancellor emphasized that "100% turn-out is unlikely even in a contested election,"[48] and that a "40% block is very potent in view of that reality."[49]

In *Kahn v. Lynch Communications Systems, Inc.*,[50] the Delaware Supreme Court used a similarly cautious approach in analyzing whether Alcatel, the minority shareholder alleged to be controlling in that case, "did exercise actual control over Lynch by dominating its corporate affairs."[51] The Court concluded that Alcatel, which owned more than 43% of Lynch, "dominated" Lynch because it was able to substitute its own judgment for that of the Lynch board.[52] As evidence, the court quoted an Alcatel-nominated director's admonition to Lynch's other board members: "[Y]ou must listen to us. We are [sic] 43% owner. You have to do what we tell you."[53] The court looked to such statements, together with evidence that the board's independent directors voted with Alcatel's directors, in upholding the lower court's finding that Alcatel exercised actual control over Lynch and dominated its corporate affairs.[54]

Such cases indicate that when a shareholder does not control an absolute majority of the votes of a corporation, it must exercise power over a *de facto* majority to be subject to fiduciary duties. In other words, controlling shareholder analysis, as currently performed, looks to whether a shareholder or group of affiliated shareholders owns enough voting shares to allow it to dictate membership on the board. This approach ignores entirely the possibility that shareholders with smaller stakes—that is, shareholders who do not have voting power clearly sufficient to determine who sits on the board of directors—might still be able to influence corporate officers or directors in less obvious ways (for example, by threatening a distracting and costly proxy fight or an embarrassing media relations campaign). It also ignores the power that the marginal impact of a shareholder's vote can have on the outcome of a corporate decision. To illustrate, suppose that a corporate action, such as a merger, must be approved by the vote of an absolute majority of outstanding shares. Suppose further that investors holding 49% of those shares oppose the merger, while investors holding another 49% support it. In such a case a 2% shareholder who provides the "swing vote" controls the outcome. Yet, a 2% shareholder could

47. *Id.* at 552.
48. *Id.* at 552 n.30.
49. *Id.*
50. 638 A.2d 1110 (Del. 1994).
51. *Id.* at 1115.
52. *Id.* at 1113-14.
53. *Id.* at 1114.
54. *Id.* at 1114-15.

not, under traditional analysis, be deemed a "controlling shareholder" with fiduciary responsibilities, because 2% is not mathematically sufficient to control the firm or its board more generally.

The conventional approach to shareholder fiduciary duties thus seems to frame the issue of shareholder control in terms of whether a particular shareholder *has absolute control over all corporate conduct as a routine matter*. The inquiry is not issue-specific. Yet, as we discuss in detail in the next Part, there are many specific issues as to which modern shareholders often have sharply divergent interests. A minority activist that focuses all of its attention on a single matter may be able, especially given other shareholders' rational apathy, to exercise significant influence over the corporation's actions within that narrow sphere. If such minority shareholders are excused from fiduciary duties on the grounds they are not "controlling," they are free to use their influence, albeit selectively, to serve themselves at other shareholders' expense.

2. *Freeze-outs and closely held corporations*

Shareholders in public corporations traditionally have been perceived not only as being passive but also as having largely homogenous interests. This belief in the uniformity of shareholders' interests has led both courts and commentators to tend to think of even controlling shareholders' duties as arising primarily in two limited factual contexts: freeze-out transactions and closely held corporations.

We first consider freeze-out cases. The term "freeze-out" refers to a transaction in which a controlling shareholder uses its influence to cause the corporation to pursue an action that results in the controlling shareholder's owning the corporation in its entirety, while minority shareholders are forced to sell their shares for cash or other securities.[55] In effect, freeze-outs force non-controlling shareholders to sell their equity to the controlling shareholder.[56] Freeze-outs present an obvious danger to minority shareholders because the controlling shareholder can use its position to effectuate the transaction at an unfairly low price. As an example, suppose a parent company seeks to acquire 100% of the equity of a partially owned subsidiary in which it holds 60% of the outstanding shares. In such a case, the parent has an incentive to set the merger price as low as possible because every $1 reduction in the merger price saves the controlling shareholder $1 while costing the controlling shareholder only 60

55. *See generally* CLARK, *supra* note 1, at 499-530 (discussing "freezeouts and buyouts").

56. A common freeze-out technique is a cash parent-subsidiary merger, in which the "parent" corporation owns a majority of the outstanding shares of the "sub." The parent corporation can, by majority rule, cause the sub to merge into the parent (or another wholly-owned subsidiary of the parent) in exchange for cash. Upon consummation of the merger, the minority shareholders have been eliminated as investors in the subsidiary corporation. *See, e.g.*, Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490 (Del. Ch. 1990).

cents. Courts have not hesitated to declare that controlling shareholders owe loyalty duties to minority shareholders in these circumstances and to subject freeze-outs to judicial scrutiny under the heightened standard of intrinsic fairness.[57]

The second fact pattern in which courts commonly treat shareholders as fiduciaries is in closely held corporation cases. Closely held corporations are characterized by having very few stockholders, substantial stockholder participation in corporate management, and the absence of a ready public market for selling their shares.[58] These features make closely held corporations fertile ground for shareholder fiduciary duty cases for two reasons. First, because closely held corporations have few shareholders and all or some are actively involved in running the business, there will often be a shareholder or group of shareholders that "controls" the corporation's actions. It is not unusual, for example, for closely held corporation shareholders to also serve as directors, officers, or key employees (and, accordingly, to rely on their salaries from the firm as their primary source of income). Second, in closely held corporations a controlling shareholder can threaten minority interests in a variety of ways above and beyond conducting a freeze-out. For example, the controlling shareholder might decide to exclude a minority shareholder from any salaried position in the firm while simultaneously refusing to declare dividends, thus cutting off any prospect of a return on the minority shareholder's investment. Closely held corporations, as a result, provide a setting in which it is especially likely that shareholder interests will conflict and that a controlling shareholder will act opportunistically. Without a liquid market to provide an exit, the position of a minority shareholder in a closely held corporation can become untenable. Subjecting controlling shareholders of closely held corporations to fiduciary duties protects minority investors trapped in such situations.[59]

The prevalence of freeze-out and closely held corporation fact patterns in the case law on shareholder fiduciary duties is understandable. Freeze-outs and closely held corporations both present situations where conflicts of interest among shareholders are common, obvious, and severe. Nevertheless, the fact that so many cases in which courts have imposed shareholder duties involve these situations can easily lead to the assumption—a mistaken one, we believe—that controlling shareholders owe fiduciary duties *only* in the contexts of freeze-outs and closely held corporations.

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57. *See Kahn*, 638 A.2d at 1115 (Del. 1994) (referring to the parent-subsidiary context as an instance in which a controlling or dominating shareholder stands on both sides of a transaction).

58. *See, e.g.*, Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975) (discussing characteristics of close corporations).

59. *See id.* at 515 (making this point).

D. *Summation*

Like corporate officers and directors, shareholders owe fiduciary duties. Courts, however, recognize shareholder fiduciary duties only for controlling shareholders, and primarily in freeze-outs and closely held corporation cases. This is not to say there are *no* cases in which fiduciary duties have been applied to non-controlling shareholders or outside the freeze-out and closely held corporation contexts.[60] Such applications are noticeably uncommon, however.[61]

It is therefore not surprising that shareholder fiduciary duties are commonly understood to exist only for controlling shareholders, and even then, principally in the contexts of freeze-outs and closely held companies. Many corporate law casebooks reflect this assumption. They treat shareholder fiduciary duties not as a uniform and general topic, but as a set of separate and specialized doctrines discussed in discrete sections treating freeze-outs and closely held corporation law.[62] Indeed, some corporate experts argue that shareholder fiduciary duties are not really "shareholder" duties at all but instead a subspecies of director duties that come into play in unusual cases where shareholders act like "shadow" directors. For example, one leading authority states that it is only when shareholders become the functional equivalent of directors that they step into corresponding responsibilities:

> Generally shareholders have no rights or obligations relative to the corporation or the other shareholders save those contained in their stock contracts. Controlling shareholders, however, have a fiduciary duty to the minority in all corporations, including publicly held corporations. This duty is a consequence of the power that controlling shareholders have to direct the corporation's affairs. Although the traditional corporate model posits that directors, rather than shareholders, direct corporate activity, this model breaks down where a single shareholder or group of shareholders owns a controlling interest. In such situations, the board is usually just a proxy for the controlling shareholder or group. The power incident to control gives rise to equivalent responsibility.[63]

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60. *See, e.g.*, Smith v. Atl. Props., Inc., 422 N.E.2d 798 (Mass. App. Ct. 1981); *see also infra* text accompanying notes 171-75.

61. *See* BLOCK, BARTON & RADIN, *supra* note 21, at 397.

62. *See, e.g.*, CLARK, *supra* note 1, at 761 (discussing shareholder loyalty duties in two chapters entitled "Close Corporations" and "Control Shifts and Insider Imperialism: Freezeouts and Buyouts"); MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 374, 678 (9th ed. 2005) (discussing shareholder loyalty duties in two sections entitled "Fiduciary Obligations of Shareholders in Close Corporations" and "Duties of Controlling Shareholders," the latter focusing on freeze-out cases); CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 407, 619 (5th ed. 2006) (discussing shareholder loyalty duties primarily in two sections entitled "Protecting Participants' Expectations in a Closely Held Business" and "Mergers and Other 'Friendly' Control Transactions," the latter focusing on freeze-out cases).

63. BLOCK, BARTON & RADIN, *supra* note 21, at 368-69 ("Just as interested directors and officers who stand on both sides of a transaction and who do not obtain disinterested

Conventional analysis of shareholder fiduciary duties is thus very cautious in its approach, interpreting shareholder duties narrowly in terms of both the situations that give rise to those duties, and the types of shareholders who are subject to them. This is understandable in the context of the assumptions, discussed in Part I.B.1 above, that shareholders generally lack influence and share common interests. As we detail in the next Part, however, these assumptions are increasingly of only historical relevance. Shareholders are becoming both more powerful and more divided, giving rise to troubling consequences. Corporate law can and should adapt to these changes.

II. THE EVOLVING ROLE OF SHAREHOLDERS IN CORPORATE GOVERNANCE

A. *The Activist Shareholder*

In 1932, renowned corporate scholars Adolph Berle and Gardiner Means described a phenomenon that has troubled corporate scholars ever since: the "separation of ownership from control" in the American public corporation.[64]

As Berle and Means put it:

> Since direction over the activities of a corporation is exercised through the board of directors, we may say for practical purposes that control [over the corporation] lies in the hands of the individual or group who have the power to select the board of directors.
>
> . . .
>
> When the largest single [shareholder] interest amounts to but a fraction of one percent—the case in several of the largest American corporations—no stockholder is in the position through his holdings alone to place important

director or disinterested shareholder approval bear the burden of demonstrating that the transaction is fair, so too controlling shareholders who stand on both sides of a transaction and who do not obtain disinterested director or disinterested shareholder approval ordinarily must demonstrate that the transaction is fair." (footnotes omitted)).

At least in theory, directors' fiduciary duties could also be implicated when a controlling shareholder uses its control to cause the firm to enter into a transaction in which the controlling shareholder has a conflict of interest. One might argue that a director who allows a controlling shareholder to push through such a transaction has breached the director's own fiduciary duty of loyalty owed to the minority shareholders. We are unaware, however, of any case where a court has held that an uninterested director breached his or her duty by doing a controlling shareholder's bidding. At least two arguments support this result. First, for a number of well-recognized policy reasons, the business judgment rule generally protects any director decision that is not tainted by a personal economic conflict of interest on the part of the director. *See* Stout, *supra* note 12, at 681. Second, director liability may not be necessary, because controlling shareholder liability can act as a substitute: the actions of a controlling shareholder who engages in a conflict-of-interest-transaction would be held to the intrinsic fairness standard. Thus, approval by a director who does not have a direct, personal conflict of interest can be safely reviewed under the deferential business judgment rule, even though at least in theory the director's judgment might be compromised by the knowledge that the director might be removed by the controlling shareholder.

64. BERLE & MEANS, *supra* note 34, at 7.

> pressure upon the management.
> . . .
> Where ownership is sufficiently sub-divided, the management can thus become self-perpetuating body.[65]

Like many modern experts, Berle and Means traced the origins of shareholder powerlessness in public companies to two distinct factors, one economic and one legal. The economic factor was the rational apathy of dispersed small investors whose individual interests were so small that it did not make sense for any single one of them, alone, to take an active role in corporate affairs.[66] The legal factor was corporate law's proxy rules, which allowed incumbent directors to use corporate funds to solicit shareholder proxy votes in support of their nominees, while requiring shareholders wishing to mount a challenge to use their personal funds to solicit proxies.[67]

Each of these two factors, which Berle and Means identified as the causes of shareholder powerlessness more than three-quarters of a century ago, is still in effect to at least some extent. But the American corporate landscape has changed substantially since Berle and Means' time. Changes in markets, business practice and business institutions, and in corporate and securities law, have seriously eroded the realism of the standard assumptions that shareholders are passive and powerless. Below, we survey some of the most important influences that in recent years have given shareholders in public firms far more power than they ever enjoyed before.

1. *The rise of the institutional investor*

When Berle and Means wrote about shareholder powerlessness in 1932, most shareholders were individuals. This situation has changed dramatically with the rise of the "institutional investor." Institutional investors—typically pension funds and mutual funds—aggregate the savings of millions of individuals into enormous investment portfolios that buy stock in public companies. As a result, institutional investors can take far larger positions in particular companies than most individual investors ever could.

Institutions have captured a larger and larger share of the total market for public equities over time, from 8% of outstanding shares in 1950 to nearly two-thirds today.[68] This trend has been widely recognized as undermining the realism of the assumption that shareholders in public companies are dispersed and powerless.[69] As Professor Bernard Black put it in his influential 1990

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65. *Id.* at 66, 78, 82.

66. *Id.* at 76. *See generally supra* note 34 (describing rational apathy problem).

67. *Id. See generally* text accompanying notes 67, 74-78 (describing how proxy rules disfavor dissidents).

68. BAUMAN ET AL., *supra* note 2, at 509.

69. *See generally* Anat R. Admati et al., *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. POL. ECON. 1097 (1994); Bernard S. Black, *Agents*

article *Shareholder Passivity Reexamined*,[70] "[C]ollective action problems, while important, seem manageable for the large institutions who are today the dominant shareholders."[71] "[T]he model of public companies as owned by thousands of anonymous shareholders simply isn't true. There are a limited number of large shareholders, and they know each other."[72]

Institutional investors are in a much more favorable position to play an activist role in corporate governance than dispersed individual investors are. Although many pension and mutual funds rely on relatively passive stock-picking strategies, especially when they hold highly diversified portfolios, a number of prominent institutional investors—including both mutual funds like Fidelity and Vanguard and pension funds like CalPERS—have emerged as activist investors willing to mount public relations campaigns, initiate litigation, and launch proxy battles to pressure corporate officers and directors into following their preferred business strategy.[73]

2. *The SEC's 1992 proxy rule amendment*s

Shareholders' ability to influence policy in public companies received an important boost in 1992, when the SEC amended its federal proxy regulations for the express purpose of permitting large shareholders to exercise their voting power more effectively.[74] Prior to 1992, the SEC had interpreted the phrase "proxy solicitation" to include any communication "reasonably calculated" to influence another shareholder's vote.[75] Because participation in a proxy solicitation triggers burdensome federal disclosure obligations, this interpretation discouraged investors from communicating with each other over matters that might be subject to a shareholder vote. The 1992 amendments eliminated this problem by exempting from the definition of "proxy solicitation" most shareholder communications not actually accompanied by a

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Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. REV. 811 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567 (1990) [hereinafter Black, *Shareholder Passivity*].

70. Black, *Shareholder Passivity*, *supra* note 69.

71. *Id.* at 608.

72. *Id.* at 574. *But see* Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 12-17 (UCLA Sch. of Law, Law & Econ. Research Paper Series No. 05-20, 2005), *available at* http://ssrn.com/abstract=796227 (advancing the view that institutional shareholders are rationally apathetic, except for union and state and local pension funds, which are the institutions most likely to engage in self-dealing).

73. *See infra* text accompanying notes 118-21 (describing CalPERs proxy campaign at Safeway).

74. *See generally* BAUMAN ET AL., *supra* note 2, at 528-29 (describing 1992 amendments and their effects); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 686-89 (2007) (describing 1992 changes).

75. *See* Briggs, *supra* note 74, at 686 (quoting 17 C.F.R. § 240.14a-1(1) (2006)).

formal proxy solicitation.[76]

The 1992 amendments also made clear that most shareholders were free to make public statements, including speeches, press releases, newspaper advertisements, broadcast media, and internet communications.[77] The 1992 amendments thus made it much easier for investors—including institutional investors and hedge funds—to coordinate with each other and combine their individual holdings into a single, much larger voting block. It also became much easier for shareholders to communicate with each other, and with the general public, concerning their views on corporate policy. The result proved to be "revolutionary" as the 1992 amendments "largely deregulated proxy contests and other shareholder insurgency activities."[78]

3. *The emergence of shareholder advisory services*

Another recent development that has magnified shareholders' collective influence is the creation of commercial "shareholder advisory" services. Shareholder advisory firms specialize in advising pension funds and mutual funds, for a fee, how to vote the proxies of the shares held in their investment portfolios. As a result, advisory services coordinate the voting policies of many different institutional investors, effectively aggregating their shares into one large voting block controlled, as a practical matter, by the advisory service itself.

By far the largest and most influential shareholder advisory service today is ISS Governance Services, formerly known as Institutional Shareholder Services (ISS). ISS offers to advise pension and mutual fund portfolio managers on how to vote the shares in their portfolios on matters ranging from director elections, to the approval of "poison pills," to the sale of the entire company.[79] ISS claims to have 3500 clients worldwide.[80]

The emergence of ISS as the dominant shareholder advisory service has dramatically reduced the collective action problem traditionally thought to

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76. *See id.* at 686-97.

77. *See id.* More recently, the SEC adopted amendments to the federal proxy rules to facilitate the use of electronic shareholder forums. Electronic Shareholder Forums, Exchange Act Release No. 34-57172, Investment Company Act Release No. 28124, 73 Fed. Reg. 4450 (Jan. 25, 2008).

78. *Id.* at 684, 687; *see also* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) (codified at 17 C.F.R. § 270.30b1-4 (2006)).

79. An important source of ISS's present success is an SEC rule adopted in 2004 requiring mutual funds to disclose to their investors how fund managers are voting the stocks held in their portfolios. *See* 17 C.F.R. § 270.30b1-4. Mutual funds have flocked to ISS to "outsource" their proxy voting decisions. *See* Institutional S'holder Servs., Proxy Voting Services for Institutional Investors, http://www.issproxy.com/pdf/votingservices.pdf.

80. *See* RiskMetrics Group, Corporate Profile, http://investors.riskmetrics.com/phoenix.zhtml?c=215573&p=irol-irhome.

plague shareholders in public firms. Not only are more and more public company shareholders large institutions, but those institutions increasingly follow the advice of a single advisory firm. In short, the widely dispersed individual shareholders of Berle & Means' day, who routinely voted with corporate management, have been replaced to a great extent by a single and far more independent-minded "voter"—ISS.[81]

4. *The rise of activist hedge funds*

Increased institutional investing, the 1992 proxy rule amendments, and the emergence of ISS have all worked together to make it easier for shareholders in public companies to play a more active role in corporate affairs than it has ever been before. Nevertheless, many large institutional investors continue to face at least one significant obstacle to activism: They desire to maintain a diversified investment portfolio. Pension and mutual funds in particular face significant legal and market pressures to diversify.[82] As a result, any single company's stock is likely to comprise only a small percentage (often far less than 1%) of the diversified institution's portfolio, and, correspondingly, the institution is likely to hold only a small percentage of any single company's outstanding stock. Accordingly, a diversified institution may routinely vote the way ISS recommends, even when this means voting against management. But it is unlikely to pursue any deeper involvement in the company's affairs, calculating that the benefits of activism (which are shared with all shareholders who own stock in the company in question) are outweighed by the costs (which are born solely by the institutional investor).

In recent years, however, a new type of institutional shareholder has emerged for whom activism is more economically rational—the activist hedge fund.[83] Hedge funds are lightly regulated investment pools that cater to wealthy investors and so are exempt from most of the disclosure requirements and other legal burdens borne by mutual funds that take investment funds from the general public.[84] Although many hedge funds rely on passive stock-picking

81. *See* Briggs, *supra* note 74, at 692-94, 702 (describing rise of ISS and how activist hedge funds appeal to ISS in order to get its institutional clients to cast votes in support of their battles with management).

82. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1049 (2007) (describing legal rules requiring many mutual funds to diversify); *id.* at 1057 n.174 (discussing pressure on pension funds to diversify to comply with prudent investor rule); *id.* at 1070 ("[M]utual funds view and market themselves as vehicles for diversification . . . . An activist strategy, however, does not mesh well with a diversification objective . . . .")

83. *See generally* Mara Der Hovanesian, *Attack of the Hungry Hedge Funds*, BUS. WK., Feb. 20, 2006, at 72; Henny Sender, *Hedge Funds: The New Corporate Activists*, WALL ST. J., May 13, 2005, at C1; Emily Thornton & Susan Zegel, *Hedge Funds: The New Raiders*, BUS. WK., Feb. 28, 2005, at 32.

84. *See generally* William W. Bratton, *Hedge Funds and Governance Targets*, 95

strategies, numerous high-profile funds use their shareholder status to push aggressively for specific corporate actions.

Activist hedge funds do not attempt to diversify their portfolios. Instead, they take large positions in as few as two or three companies and then demand that those companies pay special dividends, launch massive stock buyback programs, sell assets, or even put themselves on the auction block in order to add "shareholder value."[85] The confrontational nature of activist funds is often reflected in their names: Pirate Capital, Bulldog Investors, Steel Partners, and Cerberus Capital, to name some notable examples.[86]

Until recently, activist funds tended to target smaller companies, in which they could acquire large voting blocks at relatively low cost. The popularity of hedge funds has grown enormously in recent years, however, and by some estimates hedge funds now control as much as two trillion dollars in assets.[87] Moreover, the 1992 proxy rule amendments have allowed funds to form "wolf packs" of several funds that buy stakes in a company and together pressure its managers.[88] Activist hedge funds' power and influence have grown to the point where they are targeting much larger firms, including McDonald's, General Motors, and Time Warner.[89] The result is a new genre of public company shareholder that is aggressive, wealthy, and eager to play a role in setting corporate policy. In the words of one industry insider, because of activist hedge funds, "the balance of power is shifting away from boards."[90]

GEO. L.J. 1375 (2007); Kahan & Rock, *supra* note 82; Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation* (Vanderbilt Law & Econ. Research Paper No. 06-21, 2006), *available at* http://ssrn.com/abstract=931254.

85. Interestingly, hedge funds seem to favor mergers and acquisitions only when they own the target; they often object strenuously when they own the bidder. *See* Brent Shearer, *Dangerous Waters for Dealmakers: Shareholder Sharks Are Using Their Clout to Influence Deals*, MERGERS & ACQUISITIONS, Mar. 2006, at 30-31 (describing how activist hedge funds often oppose acquisitions by companies in which they have invested). Hedge funds' inconsistent stance on business deals probably reflects a perception that bidding companies tend to overpay, which is good news for shareholders in the target company but bad news for the bidding company's shareholders. *See generally* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989).

86. *See* Hovenesian, *supra* note 83, at 72 (describing Bulldog Investors); Thornton & Zegel, *supra* note 83, at 32, 34 (discussing Pirate Capital, Steel Partners, and Cerberus Capital Management).

87. *See In Defense of Hedge Funds*, BUS. WK., July 9, 2007, at 112 ("Hedge fund assets could hit $2 trillion this year . . . .").

88. Bratton, *supra* note 84, at 1379; Briggs, *supra* note 74, at 692; *see also* Thornton & Zegel, *supra* note 83, at 34 ("[T]he new raiders often hunt in packs.").

89. Hovenesian, *supra* note 83, at 72.

90. *Id.* (quoting Banc of America Securities' head of global mergers and acquisitions); *see also* Kahan & Rock, *supra* note 82, at 1024 ("Hedge funds have become critical players in both corporate governance and corporate control."); Sender, *supra* note 83, at C1 (quoting Morgan Stanley's head of global corporate finance as saying that "hedge funds have become the corporate activists of this generation").

5. *Financial innovation*

Yet another factor promoting greater shareholder activism is financial innovation. In the early days of the corporation, investors generally could choose between only two types of corporate securities: stocks and bonds, the vanilla and chocolate of corporate finance. Today, the capital structures of public firms have become far more complex. Investors can purchase not only stocks and bonds but also various alternative forms of equity, debt, and hybrid instruments.[91]

Financial innovation encourages shareholder activism in at least two ways. First, it creates more incentives for activism because the more complex a company's capital structure becomes, the more opportunities are presented for investors who purchase one type of security to push for corporate actions that harm the value of another type of security issued by the same company. For example, a preferred stockholder in a troubled firm might push for an asset sale to trigger its liquidation preference, while common shareholders demand a risky strategy that could raise the value of the common if it succeeds but harms the value of the preferred.[92] We discuss this sort of "rob Peter to pay Paul" investor activism in greater detail in Part II.B.3.

A second and more widely recognized reason why financial innovation has encouraged shareholder activism is that it has lowered the cost of activist strategies by allowing the separation of voting rights and economic interests.[93] Thus, a hedge fund can buy a block of common stock and vote the shares while simultaneously entering a derivatives contract that hedges away its economic interest in the stock. Indeed, the fund can take a *negative* economic position in the firm by shorting its stock and then seek to profit from using its power as a formal shareholder to push for business policies that drive the stock price *down*.[94]

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91. *See generally* Henry T.C. Hu, *New Financial Products, The Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991).

92. This consequence of capital structure complexity is discussed at some length in Partnoy & Thomas, *supra* note 84, at 35-39 (describing this as "capital structure motivated trading" and noting that such trades may be "no more than a redistribution of corporate resources to debtholders or other slices of the capital structure to shareholders").

93. *See generally* Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implication, and Reforms*, 61 BUS. LAW. 1011 (2006) [hereinafter Hu & Black, *Empty Voting*]; Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) [hereinafter Hu & Black, *The New Vote Buying*]; Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775; Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions* (Univ. of Tex. Sch. of Law, Law & Econ. Working Paper & European Corporate Governance Institute Law Wkg. Paper No. 122, 2007), available at http://papers.ssrn.com/abstract =1030721.

94. This technique would involve the fund's "shorting" the firm's stock by borrowing the stock from a broker and then selling it to a third party, subject to the obligation that the fund must later reacquire the stock and return it to the broker. If the price of the stock drops,

The problem is not just theoretical. Although hard data about hedge fund transactions and derivatives deals is hard to obtain, the business media has reported a number of recent cases in which activist hedge funds have used "empty voting" strategies in which the activist separates the right to vote shares from the beneficial ownership of those shares, and these reported cases likely reflect only the tip of the iceberg.[95] As a result, empty voting has attracted widespread interest, and a number of scholars have proposed policy solutions.[96] For now, activist strategies that divorce economic interests from voting rights in public corporations remain "largely unregulated and often unseen."[97]

6. *Proposed changes in shareholder voting rules*

So far we have focused on developments that have already worked in tandem to shift power in public corporations away from executives and boards and into the hands of activist shareholders. The shift continues, however. Shareholders stand to gain even more political leverage in the near future, as witnessed by several important proposals for changes in the rules of shareholder voting..

The most significant of these proposed changes relates to proxy access."[98] One of the greatest hurdles to shareholder action has been that dissident shareholders seeking to mount a proxy battle against incumbent boards must use their personal funds to do so, while incumbent boards can use corporate funds.[99] The SEC recently solicited comments on a proposed rule change that

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the fund will be able to cover its short position by purchasing the shares at the lower price. The fund's profit would be the difference between the price at which the fund sold the borrowed stock and the cost to repurchase the stock later, net of fees and expenses.

95. *See* Hu & Black, *Empty Voting*, *supra* note 93, at 1014-18, 1023-26 (identifying multiple recently reported cases and describing difficulties of getting information).

96. *See* sources cited *supra* note 93.

97. Hu & Black, *Empty Voting*, *supra* note 93, at 1016.

98. Jeff Gordon suggests that an even more important development may be the advent of e-proxy rules recently adopted by the SEC. These rules enable issuers and other soliciting persons (including shareholders nominating directors) to deliver proxy materials by posting the materials on a Web site and providing a notice relating to the posting. This development should substantially reduce the cost to shareholders of waging a proxy contest. *See* Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy* (Center for Law and Econ. Studies, Columbia Univ. Sch. of Law, Working Paper No. 322, 2008) *available at* http://ssrn.com/abstract=1085356.

99. *See supra* note 35. Because directors enjoy discretion to decide whether to pay the campaign costs of dissident shareholders, shareholders challenging incumbent directors are likely to be reimbursed for their expenses only if they succeed in gaining control over the board. *See* Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1106-10 (1990). Other, more minor barriers to shareholder action exist as well. For example, while shareholders have formal power to elect and remove directors, they cannot call meetings to do so, but must wait until the next regularly scheduled meeting. *See* DEL. CODE. ANN. tit. 8, §§ 141(a), 211(d) (2005).

would have allowed a dissident shareholder holding 5% or more of outstanding equity—an ownership threshold often met by activist hedge funds[100]—to propose a bylaw change that would allow the dissident to include its own director nominees in the company's proxy solicitation materials. Although the SEC ultimately elected not to adopt this version of the rule, the SEC Chairman has announced his intention to continue to consider the matter.[101] If some version of the proposed rule change is adopted, it will dramatically reduce the costs of shareholder activism for 5% shareholders by allowing them to use corporate funds to finance their battles.

A second important proposed rule change currently awaiting approval by the SEC is the NYSE's proposal to eliminate "broker voting."[102] As much as 85% of exchange-traded securities are held by brokers and banks on behalf of client investors, and a significant minority of those clients do not instruct the brokerage on how to vote their shares.[103] NYSE rules allow brokers to vote these clients' shares on "routine matters," including uncontested director elections. Because brokers almost always vote as management suggests, the result has been a reliable block of "broker votes" cast in incumbents' favor. If the NYSE defines director elections as "non-routine," as it is currently proposing, incumbent managers will lose this advantage, making it easier for dissidents to mount a challenge.

Finally, a third significant shift toward greater shareholder power is taking place at the firm level, as individual corporations rapidly adopt "majority voting" rules in director elections.[104] Under the default rules of corporate law, directors are elected by plurality voting.[105] This means the director candidate

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100. Briggs, *supra* note 74, at 697 (empirical study finding that activist funds often take large positions of more than 10% of outstanding equity).

101. *See* Kara Scannell, *Cox, In Denying Proxy Access, Puts His SEC Legacy on Line*, WALL ST. J., Nov. 29, 2007, at C1; Robert Schroeder, *SEC Floats Reforms for Municipal Securities Market*, MARKET WATCH, July 26, 2007, http://www.marketwatch.com/news/story/sec-floats-reforms-municipal-securities-market; Rachelle Younglai, *U.S. SEC Mulls 5 Pct Ownership for Proxy Access*, REUTERS, July 10, 2007, http://www.reuters.com/articlePrint?articleId=USN0931053520070710.

102. NYSE, Inc., SR 2006-92 Proposal To Eliminate Discretionary Broker Voting for the Election of Directors—Rule 452, (Oct. 24, 2006) and SR 2006-92 Amendment No. 1, (May 23, 2007), *available at* http://www.nyse.com/regulation/rules/1160561784294.html; Ted Allen, *No Change in Broker Voting Before the 2008 Season*, RISK & GOVERNANCE WKLY., *available at* http://www.issproxy.com/governance_weekly/2007/130.html.

103. Ted Allen, *SEC Hears Testimony on Broker Votes*, Risk & Governance Blog, May 25, 2007, http://blog.riskmetrics.com/2007/05/sec_hears_testimony_on_broker.html (citing sources noting that 85% of exchange-traded securities are held by banks and brokerages and that broker-cast votes account for 19% of votes cast at U.S. corporate meetings).

104. *See generally* Louis Lavelle, *A Simple Way to Make Boards Behave*, BUS. WK., Jan. 31, 2005, at 38.

105. *See* Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) ("[M]any companies use plurality rather than majority voting for board elections, which means that candidates can be elected regardless of whether they receive a majority of the security holder vote.").

who receives the most votes wins, even if the total number of shares voting in favor of the candidate falls far short of a majority. In response to activists' demands, many corporations have recently adopted some version of a majoritarian voting rule. Indeed, one recent study found that between 2006 and 2007, the percentage of Fortune 500 firms adopting some form of majority voting policy rose from 20% to more than 50%.[106] Because majority voting rules essentially turn shareholder "withhold" votes into "no" votes, the net effect of firm-level adoption of majority voting is to increase activist shareholders' leverage over directors.

These are only a few examples of the many proposed reforms currently being floated in the name of enhancing shareholder democracy. Not only have shareholders become far more powerful, the trend shows every sign of continuing.

B. *The Conflicted Shareholder*

Part I.C described how the idea of minority shareholder fiduciary duties has been neglected in part because minority shareholders in public firms have historically been perceived as passive and powerless. As we have just seen, however, this traditional perception is no longer accurate. We now consider the second belief that has led minority shareholder duties to receive scant attention—the belief that, in the rare instances in which minority activists do try to influence company policy, their efforts benefit all the firm's shareholders because all shareholders share a single economic interest in maximizing share price.

Like the presumption that minority shareholders are powerless, the belief that minority shareholders share a common economic goal has also become inaccurate.[107] Below, we explore some of the more common and troubling rifts that arise between activists and other shareholders in public firms. In exploring these conflicts it is important to understand that the shareholder schisms we describe, although endemic, are not without limit. When we speak of conflicts of interest between shareholders, we do not intend to describe simple disagreements over business strategy. Just as officers and directors who do not have personal economic stakes in an outcome enjoy the protections of the business judgment rule when they choose among competing corporate strategies, shareholders who do not have economic conflicts of interest should be free to argue, and even agitate for, the corporate policies they think serve the firm best.

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106. Press Release, Claudia H. Allen, Neal, Gerber, & Eisenberg LLP, Majority Voting in Director Elections—An Activist Success Story (Nov. 13, 2007), *available at* http:///www.ngelaw.com/news/pubs_detail.aspx?ID=777.

107. *See generally* Anabtawi, *supra* note 38, at 579-93 (describing many ways in which shareholder interests can conflict).

Similarly, we do not intend to capture honest disagreement about the proper purpose of the corporation. The business media, and even some scholars, often assert that the proper purpose of the corporation is to maximize shareholder wealth without regard to the consequences for employees, customers, or society. This idea enjoys only very limited support in corporate law, however.[108] Corporate charters typically describe the purpose of the company as anything lawful.[109] Modern case law and state "constituency statutes" similarly make clear that directors of public companies are free, in choosing firm policy, to consider not only shareholders' interests but also those of employees, creditors, customers, and the broader society.[110] Shareholders who are not tainted by an economic conflict of interest should similarly be free to use their investor status to pressure corporate managers to pay decent wages, produce safe products, and preserve the environment.

The analysis changes dramatically, however, when a shareholder stands to capture a personal economic benefit, not captured by other shareholders, by promoting a particular corporate outcome. Such situations can be directly analogized to interested transactions by corporate officers and directors. Just as officers and directors may be tempted to pursue self-interest at firm and shareholder expense when they can use their corporate powers for their personal profit, activist shareholders may be tempted to pursue self-interest at firm and other shareholder expense when they can use their new-found influence to benefit themselves. And, we argue in Part III, just as corporate law duty of loyalty rules apply to officers' and directors' self-interested transactions, self-interested shareholder activism should similarly trigger shareholder loyalty duties.

Below, we briefly survey some of the most common and substantial economic conflicts that have arisen between activists and other minority shareholders in modern public firms. As we will see, the fault lines are many and growing.[111] Far from sharing homogenous interests, minority shareholders often find themselves at economic odds with each other, and the sources of conflict are increasing.

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108. *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

109. *See* DEL. CODE ANN. tit. 8, § 102(b) (2005); Stout, *supra* note 108, at 1206-07.

110. *See* Stout, *supra* note 108, at 1207.

111. Our examples are by no means exhaustive. For example, one potential conflict that has attracted recent attention is the investment by sovereign wealth funds, pools of capital controlled by foreign governments, in voting equities of U.S. banks. Sovereign wealth fund investors potentially have economic and political interests that differ from those of other shareholders. *See* Andrew Ross Sorkin, *What Money Can Buy: Influence*, N.Y. TIMES, Jan. 22, 2008, at C1.

1. *Conflicts arising from activists' transactions with the corporation*

We begin by considering the context in which the dangers of shareholder self-interest may be most apparent, self-dealing transactions. As discussed in Part I.B, corporate law views with suspicion any transaction between an officer or director and the corporation which that officer or director serves. Similarly, corporate law has long acknowledged that business transactions between controlling shareholders and the corporations they control may pose loyalty problems.

One of the leading cases on controlling shareholder duties, *Sinclair Oil Corp. v. Levien*,[112] offers a good example. Sinclair Oil owned 97% of the equity of a subsidiary, Sinven. Sinclair used its control over Sinven to cause Sinven to contract to sell all its oil products to another, wholly owned, Sinclair subsidiary. The Delaware Supreme Court observed that "Sinclair's act of contracting with its dominated subsidiary was self-dealing," and held Sinclair liable for breach of its duty of loyalty because, through its domination of Sinven, it allowed its wholly-owned subsidiary to breach the sales contract in a fashion intrinsically unfair to the 3% minority shareholders of Sinven.[113]

The conventional understanding of shareholder loyalty duties reflected in *Sinclair* applies only to controlling shareholders. Nevertheless, as minority investors in public companies have acquired more power, it has become clear that an activist minority may also have enough clout to push through interested transactions. One of the earliest examples of this to appear on the scene was the practice of greenmail. "Greenmail" refers to a corporate repurchase, at a premium over market price, of a block of shares held by a minority investor who is in some manner opposing the company's management by, for example, threatening a proxy contest.[114] Greenmail was a common and troublesome practice during the 1980s until Congress amended the Internal Revenue Code in 1987 specifically to discourage it.[115] Nevertheless, greenmail still occurs,[116] and it can be characterized as an interested transaction between the corporation and a minority shareholder that has acquired leverage over the board and is using it to reap a personal profit at other shareholders' expense.[117]

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112. 280 A.2d 717 (Del. 1971).

113. *Id.* at 723.

114. *See, e.g.*, Viacom Int'l, Inc. v. Icahn, 747 F. Supp. 205 (S.D.N.Y. 1990); Polk v. Good, 507 A.2d 531 (Del. 1986).

115. *See* I.R.C. § 5881 (2000). *See generally* Kahan & Rock, *supra* note 82, at 1082 (discussing decline of greenmail); David Manry & David Stangeland, *Greenmail: A Brief History*, 6 STAN. J.L. BUS. & FIN. 217 (2001) (discussing decline of greenmail).

116. *See, e.g.*, Bratton, *supra* note 84, at 1413 (describing the 2002 greenmail payment by Gyrodyne to K Capital).

117. Interestingly, while lawsuits have been brought challenging greenmail payments, they have not claimed breach of shareholder duty but instead argued, unsuccessfully, either that the shareholder who received greenmail committed extortion, or that the directors who decided to pay greenmail breached *their* loyalty duties. *See* sources cited *supra* note 114.

The high profile proxy battle to remove Steven Burd as Chairman and CEO of Safeway, Inc., provides another thought-provoking example of the many ways activist investors can use their shareholder status to push for favorable treatment in their other dealings with the firm.[118] Burd was taking a hard-line stance in labor negotiations with the United Food & Commercial Workers Union, which represents grocery workers. He argued that Safeway needed to lower its labor costs to compete with non-unionized chains like WalMart. The California Public Employees' Retirement System (CalPERS), a large pension fund representing California employees, organized a proxy campaign to remove Burd from the corner office. It was soon revealed that the CalPERS campaign had been initiated by CalPERS' President, Sean Harrigan, who was also a career labor organizer and an official of the United Food & Commercial Workers' Union. Burd survived the attempt to oust him after it was widely reported that the grocery workers' union was using CalPERS as a stand-in in its battle with Safeway over pay and benefits.[119]

These are only a few examples of the creativity shareholders have shown in finding ways to use their shareholder status within the corporation to benefit themselves in their business dealings with the company. The risk of self-dealing has long been recognized in the context of freeze-out mergers arranged by controlling shareholders. But shareholders can enter into various other corporate dealings, including stock repurchases, employment contracts, and consulting and advisory agreements, that constitute interested transactions.[120] As they gain power in public firms, activist shareholders are demonstrating the same willingness to abuse their influence by promoting self-dealing transactions that controlling shareholders have previously exhibited.

2. *Conflicts arising from activists' interests in derivatives or securities of other corporations*

Conflicts of interest between activists and other shareholders in the firm can also arise when activist shareholders take "adverse positions" in derivatives or in securities issued by other companies. This possibility has attracted a good deal of media and scholarly attention in recent months in the wake of reports of several instances in which hedge funds with a clear conflict of interest

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118. *See* Tom Petruno, *Backlash Confronts CalPERS*, L.A. TIMES, May 20, 2004, at C1; James F. Pletz, *Pension Funds Seek to Oust Safeway Chairman*, L.A. TIMES, Mar. 26, 2004, at C1; Jenny Strasburg, *Safeway CEO Burd Survives Vote: Campaign to Strip Him of Chairman Role Falls Short*, S.F. CHRON., May 21, 2004, at C1.

119. *See* sources cited *supra* notes 118-21. While Burd survived, Harrigan was soon removed from the CalPERS board. Tom Petruno, *Business Applauds Shake-Up at CalPERS*, L.A. TIMES, Dec. 2, 2004, at A1.

120. *See* Emily Thornton, *Gluttons at the Gate*, BUS. WK., Oct. 30, 2006, at 58, 59 (reporting that private equity firms are using their shareholder status "to collect an array of dubious fees" from firms including "advisory," "management," and "transaction" fees).

employed activist tactics.[121] One such troubling scenario arises when an activist becomes a formal shareholder with voting power while simultaneously either "shorting" the company's shares or entering into a derivatives contract to hedge away its economic interest. For example, a hedge fund recently mounted a proxy battle at Exar Corporation despite the fact that the fund held less than 1% of Exar's shares and had hedged away almost all of its economic interest even in that small position through offsetting short transactions.[122] Indeed, taking a net short position in a company allows an activist investor to profit from using its status as a formal shareholder to push for corporate strategies that drive share price *down*.[123]

A second difficulty arises when activists take adverse positions in securities of another company. As one pair of scholars describe the problem, "a hedge fund that owns shares in Company A may try to use that position to increase the value of another position, say in Company B, rather than to maximize the share price of Company A."[124] To take one example, a number of hedge funds with equity holdings in MONY, a publicly held insurance corporation, supported the highly contested purchase of MONY by French conglomerate AXA. These funds also held convertible debt issued by AXA, the value of which would rise if the deal went through.[125] The merger was narrowly approved.[126]

On other occasions, a shareholder activist may combine both types of adverse interests. One of the most attention-grabbing recent cases of this sort of conflict of interest involved the potential purchase of King Pharmaceuticals by Mylan Laboratories.[127] Hedge fund Perry Capital, which had recently purchased nearly 10% of Mylan's common stock, supported the acquisition although industry observers perceived the deal as overpriced. Perry turned out to have a good reason to want Mylan to overpay for King. Perry was also a large shareholder in King, and it had used a derivatives contract to hedge away its economic interest in the Mylan shares it had purchased. Thus Perry stood to make money if the deal went through even if Mylan's shares declined, as bidding companies' shares often do in mergers. (An amusing irony of the case

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121. *See generally* Bratton, *supra* note 84 (discussing phenomenon and media-reported cases); Hu & Black, *Empty Voting*, *supra* note 93 (discussing phenomenon and media-reported cases); Kahan & Rock, *supra* note 82 (discussing phenomenon and media-reported cases); Martin & Partnoy, *supra* note 93 (discussing phenomenon and media-reported cases); Partnoy & Thomas, *supra* note 84 (discussing phenomenon and media-reported cases).

122. Briggs, *supra* note 74, at 702 (describing the Exar case).

123. *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1035 (2007) (describing such investors as "Darth Vader monitor[s]" of shareholder value).

124. Kahan & Rock, *supra* note 82, at 1071.

125. *See id.* at 1073-74 (describing the present case).

126. *See id.* at 1074.

127. *See generally id.* at 1075-77 (describing the Mylan-King case and media coverage).

was the fact that the proposed acquisition sparked bitter complaints from Carl Icahn, a shareholder activist who has built a career out of pushing managers to sell assets and companies. In this case, however, Icahn held the acquirer Mylan's stock.)[128]

Although the phenomenon of activist shareholders holding adverse positions in derivatives and other companies' securities has attracted much scholarly attention, including recent articles in the *Georgetown Law Review*,[129] *University of Pennsylvania Law Review*,[130] and *Southern California Law Review*,[131] the magnitude of the problem remains unclear. Some insight can nonetheless be gathered from an empirical study published recently in the *Journal of Corporation Law*.[132] It reports that, of fifty media-covered cases of activist hedge fund campaigns identified during a twenty-month period, six cases (12%) involved "questionable situations" in which the hedge fund had conflicts of interest due to investments in derivatives or other companies. Moreover, as the author observes, this figure may understate the incidence of conflicts because hedge funds must only disclose their interests in 13D filings when they acquire 5% or more of a company's securities, and "a competently advised fund that is truly bent on behavior that might not do well in the sun is simply not going to purchase enough shares to require a Schedule 13D filing."[133]

3. *Conflicts arising from activists' investments in other parts of the corporation's capital structure*

Yet a third source of conflict between shareholders in public firms, alluded to in Part II.A.5, is the increasingly complex capital structure of American corporations. Even when a company issues only two kinds of securities—say, common stock and debt—options theory predicts an inevitable conflict of interest between the debtholders (who want to preserve the company's "equity cushion" and avoid risk) and the stockholders (who favor risk because they enjoy all the upside while sharing the burden of the downside with the debtholders).[134] Today, however, most corporations issue not just common

128. *See supra* note 85 (discussing how activists often oppose mergers and acquisitions when they have invested in the bidder).

129. Bratton, *supra* note 84.

130. Kahan & Rock, *supra* note 82.

131. Hu & Black, *The New Vote Buying*, *supra* note 93.

132. Briggs, *supra* note 74.

133. *Id.* at 703-04. Curiously, even after finding a 12% incidence of potential conflicts in high-profile media-reported cases and observing that much bad behavior may be "under the radar," the author concludes "hedge fund activists rarely pursue strategies that cannot withstand the light of day." *Id.* at 703.

134. *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 482 (8th ed. 2006) (discussing the conflict of interest between bondholders and stockholders).

stock and debt but also preferred stock, convertible securities, warrants, collateralized debt obligations, and a host of other financial instruments. The potential for conflict between holders of different classes of securities has multiplied enormously. What's more, activist investors, especially hedge funds, have learned that they can profit from such conflict by taking positions in two different types of securities issued by the same corporation, and using the control rights associated with one type of security to increase the economic value of their holdings in the other type.

DiLillo v. Ustman Technologies, Inc.[135] illustrates the point. Sagaponack Partners, a private investment partnership headed by hedge fund manager Barry Rosenstein, invested $7 million in a small environmental services company (Ustman Technologies). In exchange, Sagaponack received high-interest secured notes and 40% of the company's common stock. According to their terms, the secured notes were soon converted into preferred stock with a liquidation preference of $17 million that could be triggered by the sale of substantially all the company's assets.

Only two years after making its initial $7 million investment, Sagaponack invested another $750,000 to increase its equity ownership in Ustman to 48.5% of common shares. At this point, Sagaponack used its influence over Ustman's board, a majority of whom were Sagaponack investors, to cause the board to sell substantially all the company's assets to a third party for $17.3 million.[136] All the proceeds from the sale went to pay Ustman's debts and Sagaponack's liquidation preference, with nothing remaining for the common shareholders. Sagaponack thus used its leverage as Ustman's largest single common shareholder to push through an asset sale that transformed Ustman into an empty shell and rendered its common stock worthless, but also approximately doubled Sagaponack's initial investment of $7.75 million after only three years.[137]

Sagaponack held such a large block of Ustman common stock that it was arguably a controlling shareholder subject to loyalty duties under conventional analysis. Indeed, this is almost certainly why a lawsuit was filed and the conflict of interest came to light. Nevertheless, *DiLillo* illustrates how an activist investor can profit from taking a position in one type of security issued

135. No. B148198, 2001 Cal. App. LEXIS 1527 (Cal. Ct. App. Nov. 19, 2001).

136. The asset sale also required the approval of a majority of Ustman's common shares. Sagaponack accomplished this by approaching a few other small Sagaponack shareholders and offering to buy their shares at market price after telling them that if they refused to sell, Sagaponack would simply buy shares on the open market and they would be left with nothing after Sagaponack pushed through the asset sale. Faced with this threat, the shareholders sold, Sagaponack acquired just over 50% of Ustman's common, and the asset sale was approved.

137. To add insult to injury, Rosenstein subsequently published an op-ed in the *Financial Times* entitled "Activism is Good for All Shareholders." Barry Rosenstein, Op-Ed, *Activism Is Good for All Shareholders*, FIN. TIMES, Mar. 10, 2006, at 17. This undoubtedly came as news to Ustman's other common shareholders.

by a company (e.g., Ustman common stock), and then using the control rights associated with that security to push for corporate action that diminishes the value of that security but increases the value of another type of security issued by the same corporation (in *DiLillo*, the Ustman preferred), in which the activist investor has an even larger economic interest.

For a number of reasons, it is difficult to get data on how often activist shareholders face these sorts of conflicts of interest. For one thing, because hedge funds are largely unregulated, it is difficult to get information about their investments and activities. For another, activists tend to target smaller companies, like Ustman Technologies, that are not followed by the media. Finally, because the conventional understanding of shareholder fiduciary duties confines those duties to controlling shareholders, litigation is unlikely unless an activist holds such a large stake that other shareholders can argue the activist is a "controlling" shareholder. We are unaware of any empirical study that sheds light on how often activists are tainted by conflicts due to investments in other parts of the company's capital structure. Anecdotal reports suggest, however, that it is not rare and may indeed be common for activists to take positions in more than one type of security issued by the same company.[138] To the extent this is true, conflicts of interest between activists who own multiple pieces of the company's capital structure and other investors who do not are unavoidable.

4. *Conflicts arising from activists' short investment horizons*

Finally, we turn to a source of investor conflict that has received considerable recent attention, the conflict between short-term investors who plan to sell their shares within days or months, and longer-term investors who hold their securities for years or decades.[139] The possibility of conflicts between these two types of investors is easy to understand. Less straightforward is whether the expanded shareholder duty we propose can be usefully applied to address the conflict.[140] We offer the discussion below as a possible application of our theory that deserves further consideration.

Actively managed mutual funds are notoriously short-term investors,

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138. *See, e.g.*, Briggs, *supra* note 74, at 701-02 (describing activist campaign by hedge fund Deephaven against MCI in which Deephaven held both MCI bonds and MCI stock); Thornton, *supra* note 120, at 64 (discussing how activist investor Tennenbaum Capital Partners held both equity and notes of Radnor Holdings and used its positions to influence corporate affairs); *see also* Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies*, N.C. J.L. & TECH. 223, 226-27 (2005) (describing frequent conflicts arising between venture capital firms that hold different classes of securities and other shareholders in start-up companies).

139. *See* Anabtawi, *supra* note 38, at 579-83; Kahan & Rock, *supra* note 82, at 1083-87; Jesse Eisinger, *Subplot in Contest for MCI: Fast Money vs. the Long Term*, WALL ST. J., Mar. 9, 2005, at C1.

140. *See infra* text accompanying note 178 (discussing difficulties created by requiring plaintiff to show defendant received unique benefit).

turning over 100% or more of their portfolios each year.[141] Hedge funds are even more hyperactive and may turn over their portfolios three times annually.[142] This short-term focus stands in stark contrast to the investing styles of index funds, pension funds, insurance companies, and many individual investors, who often hold shares for years.[143]

The result, it has been suggested, is short-term activists pressuring managers to pursue policies that raise share price in the short term but fail to help the company, and even harm it, in the long term.[144] Activists sometimes respond that conflict between short-term and long-term horizons is impossible: If market prices reflect a company's "true value," any increase in stock price must reflect an equivalent increase in value that benefits short-term and long-term alike.[145] This argument, however, relies on the so-called Efficient Capital Market Hypothesis (ECMH), a once-popular economic theory that was believed to demonstrate that stock prices accurately capture the fundamental economic values of corporations. In recent years, however, the ECHM has fallen into serious disrepair. Extensive evidence demonstrates, and contemporary theorists generally concede, that stock market prices often depart substantially from reasonable estimates of fundamental economic value.[146]

In particular, the "new finance" literature suggests at least three strategies for raising share price without improving corporate performance. The first is to sell the company: targets typically sell at substantial premiums, while bidding company stocks often decline.[147] Second, a special dividend or stock repurchase can raise stock price without improving corporate performance by taking advantage of downward-sloping demand.[148] Third, stock price can be driven upward temporarily by increasing short-term earnings at the expense of

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141. *See* Anabtawi, *supra* note 38, at 579.

142. *Id.*

143. *Id.*

144. One German politician has famously described activist investors as "locusts." *See* David Reilly, *A Hedge-Fund Honeymoon Is Over: German Regulator BaFin Is Probing Investor Activity in Deutsche Boerse Ouster*, WALL ST. J., May 13, 2005, at C3.

145. *See* Rosenstein, *supra* note 137, at 17 ("[T]he 'short-term' versus 'long-term' distinction is often a nonsensical cover-up for poor performance . . . . Activists generally seek to cause the stock price to reflect a company's true value, which is in the best interest of supposed 'short-term' and 'long-term' investors alike.").

146. For an extensive survey of the theoretical weaknesses of the ECMH, the empirical evidence against it, and its rapidly declining acceptance among experts, see Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 653-54 (2003).

147. A number of reasons for this peculiar pattern have been suggested, including bidder "hubris" and a downward-sloping demand curve for the target's stock. *See* Black, *supra* note 85, at 625 (quoting Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986)); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1239 (1990); Stout, *supra* note 146, at 645.

148. *See* Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CAL. L. REV. 1323, 1332 (2005); Stout, *supra* note 147, at 1239.

long-term results, e.g., by cutting research and development, or by moving revenues from future periods into the current accounting period.[149]

Perhaps not surprisingly, activist hedge funds tend to favor all three of these strategies.[150] As a result, it is possible that many activists are using their influence to push for corporate transactions that will provide them with a personal benefit—a higher stock price in the short term—while providing no benefit, or even harming, longer-term shareholders. Short-term activists were accused of playing just such a role when they objected to a planned merger between MCI and Verizon in favor of a sale of MCI at a higher price to Qwest. Highly leveraged Qwest lacked the financial strength of Verizon, and MCI's board feared that if MCI merged with Qwest, long-term investors who retained their interest in the merged entity would suffer.[151] Similarly, when a hedge fund controlled by Carl Icahn recently acquired nearly 3% of Motorola, it immediately demanded that Motorola not only drain its cash reserves but also take on additional debt in order to fund a massive stock buyback of up to $15 billion. Motorola insiders and industry analysts denounced the plan as a short-term strategy that would harm the company's future by draining it of the cash needed for research and innovation.[152]

From a social welfare perspective, strong arguments can be raised for deterring short-term activists' attempts to profit from temporarily raising prices. At best it is nonproductive "rent-seeking" (acquiring wealth by taking it from someone else, rather than by creating it)[153] that distracts managers and requires companies to spend time and money either resisting, or arranging, transactions that do not improve performance. At worst, it drains companies of resources they need for a healthy future. Thus it may be desirable to interpret shareholder duties in a fashion that deters short-term investors from using their formal status as shareholders to push for corporate strategies that they believe will temporarily inflate stock prices.[154]

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149. Anabtawi, *supra* note 38, at 581-82.

150. *See, e.g.*, Bratton, *supra* note 84, at 1379 (noting that hedge funds typically seek sale of the company or a division, or a large cash payment from a special dividend or stock repurchase); *id.* at 1413 (noting that activists also often push to cut "excess" costs like research and development).

151. Anabtawi, *supra* note 38, at 582-83; Eisinger, *supra* note 139.

152. Roben Farzad, *Activist Investors Not Welcome: Icahn's Interference at Motorola Stands in the Way of Its Mission*, BUS. WK., Apr. 9, 2007, at 36.

153. A short-term investor who temporarily raises a company's stock price and then sells the stock to someone else is essentially profiting at the buyer's expense. *See generally* Lynn A. Stout, *Are Stock Markets Costly Casinos?: Disagreement, Market Failure, and Security Regulation*, 81 VA. L. REV. 611 (1995) (discussing zero-sum nature of speculative trading from an investor welfare perspective). When rent-seeking imposes costs, it becomes a negative-sum game.

154. *See infra* text accompanying notes 139-51.

III. TOWARD A GENERAL THEORY OF SHAREHOLDER FIDUCIARY DUTIES

A. *Past and Proposed Responses to Activist Shareholder Overreaching*

As we saw in Part I, the twin assumptions that minority shareholders are passive and powerless, and that they share homogenous interests, have distracted attention away from the question of shareholder duties. Instead, corporate scholarship has focused on the "agency cost" problem of protecting dispersed shareholders in public firms from managerial (and, sometimes, controlling shareholder) overreaching. It is becoming increasingly apparent, however, that minority investors can play the part of corporate villain as well as corporate victim. This was first widely recognized in the 1980s, when attention focused on the activities of individual "raiders" and the practice of greenmail. More recently, the focus has been on hedge funds, as the SEC has pondered their regulation and law reviews have published a slew of scholarly articles discussing the "dark side" of hedge fund activism.[155]

Part II argued that activist shareholder overreaching is only likely to grow as shareholders become more powerful and more divided. How, then, should corporate law respond to this development? So far, regulators have tended to address minority shareholder opportunism in an *ad hoc* fashion that focuses on particular activists or particular activist tactics. For example, during the 1980s, the practice of greenmail received considerable negative attention. Congress responded by amending the tax code to impose a discouraging tax on greenmail payments.[156] Similarly, as hedge funds became more powerful, the SEC attempted to regulate them by requiring hedge fund managers to register as investment advisors.[157]

Corporate scholars have also generally responded to instances of shareholder overreaching by proposing *ad hoc* solutions that discourage particular forms of shareholder misbehavior yet leave the door open for activists to devise even more ingenious, alternative means of enriching themselves at others' expense. Frank Partnoy and Shaun Martin, for example, suggest that one policy response to the problem of voting "encumbered" shares is to allocate votes based not on formal title to shares but on real "ownership" of the economic residual interest in a corporation's equity.[158] Even assuming this is achievable, it does nothing to address the possibility that activists will

155. *See supra* notes 74, 82, 84, 93.

156. *See supra* text accompanying note 115.

157. The D.C. Circuit vacated the SEC's rule six months later, and the agency is still mulling its response. *See* Troy A. Paredes, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 4-6 (Wash. Univ. in St. Louis, Sch. of Law, Working Paper No. 07-05-01, 2007), *available at* http://ssrn.com/abstract=984450 (discussing 2004 SEC rule).

158. *See* Martin & Partnoy, *supra* note 93, at 804-09.

turn to other, equally ingenious ways to pursue self-interest.[159] Henry Hu and Bernard Black suggest enhanced disclosure when investors use derivatives to decouple votes from economic interest, but acknowledge a more substantive response may be needed.[160] Lucian Bebchuk, a dedicated advocate of greater shareholder power, has similarly offered *ad hoc* solutions in response to the objection that some short-term investors might use their increased influence to promote corporate strategies that harm the firm's long-run prospects. For example, Bebchuk argues that if short-termism is a problem, then shareholder proposals can be required to garner majority approval in not one but two successive annual meetings.[161]

What academics and regulators have failed to recognize is that the foregoing instances of perverse shareholder incentives are neither isolated nor unique. Rather, they are symptoms of a larger underlying problem—the problem of reining in minority shareholder opportunism in public corporations as shareholders become more powerful and more diverse. By their very nature, responses tailored to particular forms of shareholder opportunism tend to do a poor job of addressing concerns about shareholder conflicts of interest beyond the specific situation at hand. To take just one example, Bebchuk's proposal cannot address shareholder conflicts of interest unrelated to the time horizon over which investors expect to hold their shares. *Ad hoc* solutions also tend to be after-the-fact (they are imposed after the problem has already become large enough to attract attention) and to lack proportionality (they remain in place even if the problem proves not to be as serious as originally feared, or disappears entirely). Finally, they are overbroad, regulating categories of entities and types of transactions without regard to whether the particular entity or action poses a problem.

B. *Fiduciary Duties as a Response to Shareholder Overreaching*

We suggest treating the underlying disease, rather than merely trying to ameliorate its symptoms. The underlying disease is shareholder opportunism, a problem that parallels the officer and director opportunism that has received so much attention in the corporate law literature on "agency costs." Perhaps there is a ready remedy for shareholder opportunism that mirrors the remedy corporate law has developed for officer and director opportunism—the broad

159. *See id.* at 792-93 (acknowledging this point).

160. Hu & Black, *The New Vote Buying*, *supra* note 93, at 864 (proposing disclosure of the ownership of voting rights and economic interests in shares as an initial step to addressing decoupling).

161. Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 8, at 870-75, 883-84 (claiming that appropriate rule design, such as holding and ownership requirements, can address concerns that shareholders will use their power to serve their own interests, and particularly proposing that a proposal approved in an annual meeting could become effective only after the next annual meeting, if no decision to reverse the earlier decision is approved in that meeting).

application of shareholder fiduciary duties in general, and the duty of loyalty in particular.

In this Part, we reexamine the conventional understanding of shareholder loyalty duties with an eye to adapting those duties to fit recent changes in shareholder influence and interest. As we saw in Part I.B, conventional analysis treats shareholder fiduciary duties as exceptional in nature, with shareholders generally presumed to be free to pursue their self-interest except when they exercise a degree of control over the firm equivalent to that of the corporation's directors. An observer so inclined could interpret case law even more narrowly, restricting controlling shareholders' fiduciary obligations to just freeze-outs and closely held corporations.

We believe that such a restrictive reading is neither necessary nor wise. Instead, we propose that all shareholders, like all directors and officers, be viewed as owing latent duties to the firm and their fellow shareholders. These latent duties would be triggered whenever a particular shareholder—whether or not it is technically a shareholder capable of controlling the boards' decisions as to all matters—in fact manages to successfully influence the company's actions with regard to a particular issue in which that shareholder has a material, personal economic interest. In other words, we believe that it is now time to expand both our notions of when a shareholder should be deemed to have "control" and our conception about the kinds of circumstances in which the exercise of that control poses a threat to the firm or to other shareholders.

Our suggested approach has two principal components. First, shareholder fiduciary duties would not, as it is now, be triggered by a particular shareholder's ability to direct corporate decision-making in the abstract, but rather by that shareholder's ability to influence the outcome of a particular corporate decision in which it has a personal conflict of interest. This change in level of analysis—from the general corporate level to the level of a discrete issue—defines the idea of "control" more expansively to account for the reality that modern shareholders can influence corporate policy through a variety of strategies that do not require them to control a numerical majority of the firm's voting shares.[162] Thus, we would say that a shareholder "controls" corporate conduct whenever its action is a determinative, or "but for," cause of the particular corporate decision in issue.[163]

Second, we take the position that the duty of loyalty should be activated by *any* factual situation—including, but not limited to, freeze-outs and closely held corporations—in which a shareholder seeks to promote a corporate strategy or

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162. ISS has stated that constructive dialogue between shareholders and corporations has replaced confrontation, with communications taking "place off stage, the results out of the limelight." INSTITUTIONAL S'HOLDER SERVS., 2004 POSTSEASON REPORT, A NEW CORPORATE GOVERNANCE WORLD: FROM CONFRONTATION TO CONSTRUCTIVE DIALOGUE 3 (2004), *available at* http://www.issproxy.com/pdf/2004ISSPSR.pdf.

163. *See* Hetherington, *supra* note 36, at 935 ("[A]n adverse interest becomes important only when the shareholder's vote determines the outcome of a corporate issue.").

transaction in which that particular shareholder has a material, personal pecuniary interest. This approach recognizes that, while shareholder conflicts of interest are perhaps most obvious in freeze-outs and closely held corporations, they can arise in a host of other situations as well, including conflicts over merger strategies, special dividend declarations, and stock repurchases.

Our proposal may at first appear a radical reconception of shareholder fiduciary duty. We believe, however, that it is in fact a natural extension of basic corporate law principles, as well as faithful to the underlying purposes of fiduciary doctrine. Indeed, we argue that the foundations of an expanded shareholder duty have already been laid in existing case law. Moreover, our approach offers a response to activist shareholder misbehavior that is simultaneously sweeping and tailored to the problem at hand, and that employs the strength and adaptability of the common law to deal with conflicts of interest as they arise, and not just after the fact.

The balance of corporate decision-making power between managers and shareholders is shifting rapidly in the direction of shareholders. If that shift is to prove beneficial—if the move toward greater "shareholder democracy" is to increase shareholder value rather than destroy it—it must not take place without limitation. Rights must be coupled with responsibilities, and the common law doctrine of shareholder fiduciary duty is especially well suited to meet this challenge.

1. *Expanding the notion of control*

The purpose of corporate fiduciary duties is to restrain self-interested behavior by persons in a position to exert control over the corporate entity. Existing case law already applies this principal not only to corporate officers and directors but also to shareholders When shareholders exercise corporate power, they "are acting for the corporation and for each other, and they cannot use their corporate power in bad faith or for their individual advantage or purpose."[164] The key question is what form and degree of control over the corporation must a shareholder exercise to trigger fiduciary duties.

In answering this question, it is important to bear in mind, as Deborah DeMott has cautioned, that "[s]hareholders' control is often latent and indirect in form."[165] It is a mistake to view the idea of shareholder control as an all-or-nothing inquiry (either a shareholder has complete "control" or it has none). Shareholder power and influence can depend on context. At one extreme lies the sole shareholder who holds 100% of a firm's outstanding voting stock and

164. Kavanaugh v. Kavanaugh Knitting Co., 123 N.E. 148, 152 (N.Y. 1919) (citation omitted).

165. Deborah A. DeMott, *The Mechanisms of Control*, 13 CONN. J. INT'L L. 233, 236 (1999).

enjoys virtually complete authority over every decision made by the firm's board of directors.[166] At the other extreme is the rationally apathetic, atomized individual investor who has no influence over anything and indeed cannot be bothered to return a proxy by mail. Between these two extremes lies a vast range of possible allocations of power between individual shareholders and directors. Indeed, more than one shareholder or shareholder group can be said to "control" the firm in some fashion or another.[167]

The inquiry into whether or not a shareholder has control for purposes of activating the latent duty of loyalty is, accordingly, best framed as an inquiry into whether a particular shareholder can, formally or informally, influence corporate behavior with respect to a particular issue. The relationship between shareholder and board need not be as close as that of "puppeteer" and "puppet."[168] Any attempt to exercise influence that produces the desired result—put differently, any shareholder act that is a "but for" cause of some corporate transaction or strategy—is an exercise of *de facto* shareholder control.

This formulation goes beyond the scope of the traditional shareholder control test in two important ways. First, it is context-specific, meaning it determines whether a shareholder is a controlling shareholder by referring to the role that the shareholder played with respect to a particular corporate decision. If a minority shareholder influences a particular corporate action, such as a decision to declare an extraordinary dividend, in a determinative way, it will have satisfied the control test with regard to that specific action.

A second, related distinction between our definition of shareholder control and the existing test is that our formulation does not rely on the sort of arbitrary threshold for voting power that underlies current doctrine. Contemporary case law automatically deems a shareholder "controlling" if it has the right to vote a majority of the company's outstanding shares. Although in theory the control test can reach less-than-majority shareholders, as we saw Part I.B.2, courts have set a high bar for finding a minority shareholder has exercised "actual control," holding the test met primarily when the minority shareholder controls such a large block it represents a majority of the shares likely to be voted, given other shareholders' rational apathy.[169] In contrast, our test would treat even a 1% shareholder as controlling if that shareholder's assent were essential in determining the outcome of the vote at issue. Moreover, our formulation recognizes that minority shareholders can exercise control even when they are

166. We say "virtually" because even here there are marginal procedural costs involved in replacing the board. Even 100% shareholders "once having elected directors, [do] not have a right thereafter to interfere. To impose a duty of obedience on directors . . . would conflict with the fundamental point that corporate law assigns ultimate managerial power and responsibility to directors." *Id.* at 253 (footnote omitted).

167. *See infra* text accompanying note 174.

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

169. *See supra* text accompanying notes 44-54.

not voting. For example, a shareholder may be able to determine a board's decision with regard to a particular matter—say, a share repurchase program—by threatening a proxy battle, or by undertaking an aggressive public relations campaign directed at the board. This is a favorite tactic of hedge fund managers, who have been known to personally attack a CEO for "play[ing] tennis and hobnob[bing] with [his] fellow socialites."[170]

Traditional case law offers a basis for this expanded notion of shareholder control. *Smith v. Atlantic Properties, Inc.*[171] is an oft-cited decision involving a closely held corporation with four shareholders and a charter provision that required dividends to be approved by an 80% shareholder vote, giving each of the four partners an effective veto. After one shareholder had a falling-out with the other three, he steadfastly refused to approve dividends, either out of spite or a desire to minimize his personal tax liability. The unfortunate effect was to trigger tax penalties on Atlantic Properties' accumulated earnings, to the distress of the other three shareholders, who filed suit. The court found that the recalcitrant minority shareholder had violated his duty of loyalty to his fellow shareholders, quoting case law for the principle that shareholders "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other shareholders and to the corporation."[172] The court went on to observe that the 80% provision, by giving the minority shareholder power to veto dividends, had "substantially the effect of reversing the usual roles of the majority and the minority shareholders. The minority, under that provision, becomes an ad hoc controlling interest."[173]

Smith v. Atlantic Properties is a closely held corporation case. Nevertheless, its logic applies equally well to minority shareholders in public companies. When a single shareholder's actions determine the outcome—when an activist successfully extracts greenmail, or a hedge fund with a 5% stake casts the deciding vote in a hotly-contested merger—that minority activist, like the minority shareholder in *Smith v. Atlantic Properties*, has exercised "*ad hoc*" control and triggered latent loyalty duties.[174]

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170. Kahan & Rock, *supra* note 82, at 1029 (quoting *Third Point Demands That Star Gas CEO, Irik Sevin, Resigns and Returns Keys to Company Car*, PR NEWSWIRE, Feb. 14, 2005 (internal quotation marks omitted)).

171. 422 N.E.2d 798 (Mass. App. Ct. 1981).

172. *Id.* at 801 (quoting Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (1975) (internal quotation marks omitted)).

173. *Id.* at 802 (footnote omitted).

174. As the second example suggests, when a vote is hotly contested, more than one shareholder may be in a position to cast the block of votes that carries the day. For example, when a merger is approved by a 51% to 49% shareholder vote, any shareholder that holds 2% or more of the company's shares and votes those shares in favor of the merger can be said to exercise ad hoc control and be a "but for" cause of the merger. It is important to recognize that this does not mean that any shareholder holding 2% or more who votes in favor of the merger is subject to potential liability, however. Shareholder fiduciary duties are only triggered when the shareholder in question not only exercised ad hoc control, but also had a significant conflict of interest. In such a case, close scrutiny of the fairness of the

2. *Expanding the notion of shareholder conflicts of interest*

In addition to expanding the idea of shareholder control, our approach would also expand the application of shareholder fiduciary duties in a second fashion, by applying the duty of loyalty to any corporate transaction or strategy that provides one or more shareholders with a material, personal pecuniary benefit not shared by other shareholders. This approach rejects any claim that shareholder conflicts of interest arise only in freeze-outs and closely held corporations, or that shareholder fiduciary duties should be limited to those contexts. Instead, we propose a broad-brush approach that mirrors the flexible approach typically taken in duty of loyalty cases involving corporate officers and directors. Rather than trying to identify isolated instances which shareholder conflicts arise, our approach instead asks the larger question typically asked in director and officer fiduciary duty cases: Does the shareholder have any material economic interest, in any form, that is different from other shareholders' interests in the matter?

Despite the common pattern of courts applying shareholder fiduciary duties primarily in the freeze-out and closely held corporation contexts, an open-ended and fact-specific approach to finding potential conflicts is consistent with corporate case law and particularly with the seminal case of *Sinclair Oil Corp. v. Levien*.[175] In *Sinclair*, the controlling parent corporation did not exploit the minority shareholders in its partially held subsidiary by arranging a freeze-out merger. Rather, it used its control over the subsidiary to benefit itself by causing the subsidiary to sell it petroleum products on favorable terms. *Sinclair* thus illustrates how, when presented with fact patterns that fall outside the standard freeze-out context but nevertheless raise clear conflict of interest issues, courts have responded by imposing loyalty duties on controlling shareholders.

We would also incorporate another important aspect of conventional loyalty doctrine into our proposed expansion of shareholder duties, the principle that a conflict of interest can exist not only when a shareholder causes the corporation to pursue a transaction or strategy that clearly and affirmatively harms the corporation or other shareholders but also when the controlling shareholder uses his power over the corporation to promote a transaction that does not result in obvious harm but provides the controlling shareholder with a personal benefit that is not shared with other shareholders. This prophylactic rule is designed to discourage self-interested behavior in situations in which it may be difficult or impossible to prove actual injury to the corporation. When it is applied, the appropriate remedy is not to try to measure harm, but instead to require the shareholder to disgorge any personal benefit reaped from the tainted

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shareholder's action is both appropriate and desirable.

175. *See supra* text accompanying notes 112-15 (discussing *Sinclair*).

transaction.[176] When a more expansive view of who exactly is a "controlling" shareholder is combined with *Sinclair*'s fact-intensive approach to finding conflicts of interest and the principle that an unshared benefit may be a loyalty violation,[177] shareholder fiduciary duty rules can address many of the forms of opportunistic minority shareholder conduct in public corporations discussed in Part II.B.

3. *Incorporating traditional loyalty defenses*

On first inspection, the suggestion that all shareholders should be subject to a latent fiduciary duty of loyalty might lead a casual observer to conclude the natural result will be an explosion of litigation. This is not the case. The practical scope of loyalty duties can and should be contained, and litigation should be confined to cases presenting real and serious conflicts of interest, through several restrictive measures. One of the most important is to allow shareholders accused of breaching their duty of loyalty to use the procedural rules and affirmative legal defenses employed in cases involving officers and directors accused of breaching loyalty duties. These procedures and defenses have proven effective at discouraging frivolous litigation in that context, and there is no readily apparent reason to believe that they would not be similarly effective at protecting shareholder defendants from frivolous litigation as well.

One such protection is the plaintiff's burden of alleging facts demonstrating that the shareholder defendant (1) exercised influence and (2) had a material economic interest in the outcome that differed from that of other shareholders. The number of cases in which a plaintiff can make both showings is likely to be small, and also likely to involve circumstances where judicial scrutiny is appropriate and desirable. This is because investors generally can use formal shareholder status to influence corporations in three ways: (1) by voting; (2) by filing suit against the firm or its managers; and (3) by publicly seeking to embarrass or threaten incumbent management with a proxy fight or public relations campaign. Very few shareholders engage in the last two

176. This approach is used perhaps most often in loyalty cases involving allegations of "taking a corporate opportunity," where disgorgement is a common remedy. *See, e.g.*, Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1061 (Del. Ch. 2004) (finding controlling shareholder breached loyalty duties to corporation by concealing the fact that a third party was interested in purchasing a corporate asset and instead arranging the sale of the asset to another entity he controlled). Similarly, trading on insider information has been held to be a loyalty violation despite the absence of any obvious harm to the company because the insider in question used his access to corporate information to his personal benefit. *See, e.g.*, Diamond v. Oreamuno, 248 N.E.2d 910 (N.Y. 1969).

177. It is important to bear in mind that our proposed loyalty duty does not require a shareholder that sells its shares at a premium to share that premium with other shareholders. A shareholder that is selling its shares is not, by that act, trying to use its shareholder status to exercise power over the firm or its managers, but is engaging in a market transaction with an unrelated party. There is some suggestion in case law that such a selling shareholder does have to exercise care in choosing a buyer to purchase control, however. *See supra* note 26.

activities, and those that do are exactly the activists on whom it is most desirable to impose loyalty duties. Of course, all shareholders can vote. This does not mean that all shareholders are potential defendants in loyalty cases, however. Only in the relatively rare case where a vote is hotly contested and the outcome determined by a small margin can a plaintiff allege the outcome was determined by the vote of a particular minority shareholder who exercised "*ad hoc*" control.

Even then, litigation cannot be sustained unless the plaintiff can also allege facts establishing that the minority shareholder in question had a material personal economic interest in the outcome. This means that the plaintiff must allege facts supporting a specific conflict of interest of the sort discussed in Part II.B. Moreover, the conflict must be substantial ("material") and not *de minimis*. Only then, and only if the shareholder subject to the conflict exercised *de facto* control, can a suit can go forward. It is then that judicial scrutiny is most needed.

It should be noted that the requirement that the plaintiff allege facts showing a material benefit not shared by other shareholders presents an obstacle to the use of shareholder fiduciary duties to address conflicts between short-term and long-term shareholders. To show that an activist investor was subject to such a conflict, a plaintiff would have to show that the investor had either already sold its interest, or intended to sell it in the very near future. The plaintiff would also have to show that the stock price increase resulting from the activist's efforts was only temporary, and so did not equally benefit long-term shareholders. We acknowledge that it will be difficult to make such a showing in most cases, as the temporary nature of the price increase will become apparent only after some time, and then any decline could be attributed to other causes. Thus, the expanded shareholder fiduciary duty we propose may prove more difficult to employ against conflicts of interest due to investors' differing time horizons than to other shareholder conflicts of interest.[178]

Let us return now to the question of what happens in a situation in which a plaintiff can indeed demonstrate both exercise of *ad hoc* control and a material conflict of interest. Even then, an activist shareholder defendant retains an important escape route against liability. That escape route is the traditional defense, available to officers, directors, and controlling shareholders accused of loyalty breaches, that while the transaction at issue was tainted by self-interest it was nevertheless intrinsically fair in terms of both price and process. If a minority shareholder can show that the corporate transaction at issue was intrinsically fair to the firm and other shareholders, there similarly should be no liability. It is only if the transaction is unfair—which is again a situation where liability is appropriate—that the defendant shareholder will be held liable.

Finally, Section 144 of the Delaware General Corporation Law[179] provides

178. *See supra* text accompanying note 140.

179. DEL. CODE. ANN. tit. 8, § 144 (2005). There remains a question about whether a

two additional defenses for corporate officers and directors who enter into interested transactions. These defenses might be extended to minority shareholders as well. The first defense, found in Section 144(a)(2), is that an interested transaction was approved, after full disclosure of the material facts of the transaction and the conflict of interest involved, by a majority of the firm's disinterested shareholders.[180] Case law has extended this defense to controlling shareholders, through the "majority of the minority defense"—that is, the defense that an interested transaction with the majority shareholder was approved by a majority of the remaining minority shareholders.[181] There is no logical reason not to extend this defense to minority shareholders. For example, a greenmail payment raising loyalty questions is far less troublesome if presented to and approved by the informed majority of the shareholders who did not receive greenmail.

The second procedural defense provided in Section 144(a)(3) is that an interested transaction was approved by a majority of the corporation's disinterested directors.[182] While the defense is available to officers and directors by the terms of the statute, case law has been reluctant to extend it to controlling shareholders for the obvious reason that it is hard to imagine how any director can be truly independent of a controlling shareholder that can easily remove her from the board. As a result, courts have been skeptical of the notion that "independent" director approval saves a controlling shareholders' interested transaction from further judicial scrutiny or even shifts the burden of proof.[183]

We believe a similar skepticism is called for when the defendant is a minority activist, although for somewhat different reasons. While an activist investor cannot easily remove a director, it can threaten to launch a proxy fight to do so, and can make the directors' life difficult in other ways (e.g., through an embarrassing and sometimes personalized public relations campaign).[184] Thus, we are disinclined to attach too much importance to the fact that a greenmail payment, for example, was approved by the company's board (as

finding that a defendant met these procedures insulates that defendant from liability for breach of the duty of loyalty or simply shifts the burden of proving intrinsic unfairness back onto the plaintiff. *See* Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997) (discussing this question); *see also supra* text accompanying notes 21-24.

180. DEL. CODE. ANN. tit. 8, § 144(a)(2).

181. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1982) (discussing defenses as applied to controlling shareholder).

182. DEL. CODE. ANN. tit. 8, § 144(a)(3).

183. *See, e.g.*, Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1115-18 (Del. 1994) (finding that even independent directors not employed by or otherwise financially dominated by a controlling shareholder may nevertheless be dominated by that shareholder); *see also Weinberger*, 457 A.2d at 709 n.7 (suggesting that approval of interested transaction with controlling shareholder by committee of disinterested directors simply helps to meet the "fair dealing" prong of the substantive fairness test).

184. *See* Kahan & Rock, *supra* note 82, at 1029 (describing one such personal attack).

indeed virtually all greenmail payments are). Nevertheless, for our purposes, the applicability of this defense to minority shareholders need not be resolved here but could be worked out by the courts in the context of actual cases, just as courts are working out its applicability to controlling shareholders.[185]

IV. OBJECTIONS

Having outlined the nature of the expanded shareholder duties we propose, we now turn to the primary objections likely to be raised in response to our proposal. In particular, we anticipate that extending loyalty duties to activist shareholders may be critiqued as (1) increasing litigation, (2) chilling beneficial shareholder activism, and (3) being unnecessary in light of the protections offered by majority shareholder voting.

A. *Increased Litigation*

By its very nature, the idea of expanding shareholder loyalty duties inevitably raises the possibility of increased litigation. It is important to bear in mind, however, that the possibility of increased litigation does not alone mean that expanding duties is undesirable. We should be willing to tolerate the costs of adding duties if they are offset by greater benefits.

First, as discussed in Part III.B.3, the shareholder duty we propose is subject to the same procedural and substantive defenses designed to discourage frivolous and inappropriate litigation as the conventional duty of loyalty applied to officers, directors, and controlling shareholders. Just as in the case of conventional loyalty duties, these defenses will help ensure that lawsuits to enforce minority shareholder loyalty duties are filed both rarely and appropriately.

Second, it is generally accepted that, when applied to corporate officers and directors and controlling shareholders, the costs of recognizing and enforcing loyalty duties in the courts are more than worthwhile, even though the result is more litigation than if there were no such duties. This is because loyalty duties are understood to play a valuable role in preventing managers and controlling shareholders from succumbing to the temptation to enrich themselves at the firm's and shareholders' expense.

As minority shareholders have begun to acquire the same kind of power to influence corporate actions, at least with regard to specific issues, the same can

185. We note that judicial unease over allowing approval by independent directors to cleanse a controlling shareholder transaction is not tantamount to a presumption that such directors were themselves conflicted with respect to the transaction. Consequently, the actions of directors and of shareholders in a transaction in which a controlling shareholder engaged in a conflict-of-interest transaction would likely be reviewed under different standards. *See supra* note 63.

be said of them. Indeed, the case for loyalty duties may be even stronger in this context. Misbehavior by officers and directors is constrained by other powerful forces, above and beyond the threat of liability, that do not apply nearly as strongly to minority shareholders. For example, reputational concerns that might discourage an executive or board member from entering a blatantly self-interested transaction are far less likely to dissuade a hedge fund investor. Not only is a hedge fund manager's reputation unlikely to suffer as a result of grasping behavior, he may even be rewarded for it by his own investors, who stand to profit from it. The market for corporate control is similarly unlikely to deter minority shareholders from behaving opportunistically. Whereas managers who steal from their firms risk being ousted, activist shareholders who indulge in self-dealing do not face this risk. Thus, fiduciary duty rules may be even more important in the shareholder context than they are for managers.

B. *Chilling Effects*

Many contemporary experts in corporate governance believe that shareholder oversight plays an important role in controlling managerial misbehavior.[186] This belief, in turn, has played an important role in bringing about the reapportionment of influence from managers to shareholders described in Part II.A. According to this perspective, making firms more accountable to shareholders improves corporate performance by giving managers less discretion to pursue goals other than shareholder wealth maximization.

If this is true, it is reasonable to be concerned that imposing stronger fiduciary duties on shareholders will interfere with their ability to effectively monitor managers' behavior. Under current case law, shareholders have wide latitude to influence corporate policy in any way that they see fit. Imposing fiduciary duties on activist shareholders creates a risk of liability that may discourage at least some shareholders from taking an active role in corporate governance.

Our first response to this concern is that, though plausible, it seems overstated. Although much has been made of the potential benefits of shareholder activism, as we have seen, activists often have private interests that are substantially different from enhancing overall shareholder wealth. Modern shareholders are characterized by deep and growing rifts, creating an inevitable risk that shareholders will use their power not to monitor managers for the greater good but to enrich themselves at others' expense. Greater empirical research could shed light on how shareholders direct their activism, and more should be done. Meanwhile, the limited data available is inauspicious. Studies show that mutual funds and pension funds that employ activist strategies fail to

186. *See* sources cited *supra* note 8 (articles on shareholder power).

produce long-term benefits for shareholders,[187] and while data on hedge funds' activism is just beginning to appear and be scrutinized, the results are similarly uninspiring.[188] This is not to say that activism cannot benefit shareholders, only to suggest that the problem of chilling shareholder activism may not be as stark as it might at first appear.

Second, our proposed fiduciary duty regime leaves ample room for unconflicted shareholders to use their power. A pension or mutual fund seeking to limit executive pay would not be vulnerable to a claim that it had violated its fiduciary duties to other shareholders because, regardless of whether limiting executive pay helped or harmed corporate performance, the effects would be felt equally by the activist and all other shareholders.[189] (The situation would be quite different, of course, if the activist were seeking to limit executive pay while simultaneously demanding that the corporation hire it as a highly paid human resources advisor.) Similarly, an unconflicted shareholder activist would be free to agitate for the corporation to pay higher wages or fight global warming.[190] As discussed in our introduction to Part III, loyalty duties are not involved when shareholders without an economic conflict of interest disagree honestly on business strategy or the social purpose of the firm.

Finally, our proposal permits even shareholders with conflicts of interest to participate in corporate governance, provided they are willing to risk their conduct being analyzed under the entire fairness standard of review. If they can demonstrate that their actions do not benefit their private interests to the detriment or exclusion of other shareholders, they will not be deemed to have breached their duty. Our proposal thus permits even conflicted shareholders to take actions they can demonstrate benefit other shareholders.

The end result is that our proposal preserves aspects of "shareholder democracy" that are unbiased while filtering out the elements of shareholder activism that are conflicted and that the activist cannot persuade a court (or a majority of the firm's unconflicted shareholders) are beneficial to the firm. We

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187. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* 2-3 (European Corporate Governance Inst., Fin. Working Paper No. 139/2006, 2007), *available at* http:/ssrn.com/abstract=948907 (citing studies).

188. *See* April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* 21, 44 (European Corporate Governance Inst., Fin. Working Paper No. 140/2006, 2006), *available at* http://ssrn.com/abstract=913362 (finding that hedge funds "target good-performing firms" and that in the 12 months after the fund becomes a shareholder, earnings per share and return on assets actually decline); *see also* Bratton, *supra* note 84, at 1422 (concluding that "it is not safe to assume one would beat the market by investing in a portfolio of hedge fund targets"). *But see* Brav et al., *supra* note 187, at 3 (finding that sample of activist funds generated positive abnormal returns, but only in cases where the activism led to sale of the company or spinning off assets).

189. *See* Lorraine Woellert & Eamon Javers, *Attack of the Shareholders*, BUS. WK., Mar. 5, 2007, at 9 (describing institutional shareholder efforts to get a say on executive pay).

190. *See Shareholder Proposals: ExxonMobil Denied No-Action Relief for Proposals Raising Environmental Issues*, 37 Sec. Reg. & L. Rep. (BNA) 613 (2005) (reporting shareholder proposal to ExxonMobil regarding company's stance on global warming).

think this approach is a reasonable way to try to preserve the benefits of greater shareholder power as a check on managerial misbehavior, while limiting its potential for abuse.

C. *Majority Voting*

Yet another objection some might raise to our proposal is that it is simply unnecessary because non-controlling shareholder overreaching is limited by the principle of majority rule. According to this argument, minority shareholders cannot pursue private agendas to the detriment of other shareholders because they are unable to obtain the support they need to push through their initiatives. For example, a union pension fund opposing a sale of the company out of fear it will eliminate jobs will have trouble garnering support from other shareholders to veto the deal. Only activist initiatives that increase shareholder value should succeed.

There are a number of difficulties with this argument. Most centrally, it ignores that fact that the same rational apathy that makes it difficult for public company shareholders to police managers makes it difficult for them to police each other. To oppose an overreaching activist, other shareholders must first know about the overreaching; then, they must be able to take action to prevent it; and, finally, they must overcome the free-rider problem that tempts each to sit back and hope another shareholder will do the work.

Each of these requirements is problematic. Activists rarely go out of their way to publicize their conflicts of interest. To the contrary, they try to obscure them, and their disclosure obligations are often partial at best.[191] This makes it difficult for unconflicted shareholders to obtain information about activists' real motives, even should they be inclined to do so. Second, it can be difficult even for informed shareholders to prevent an activist from pushing through a corporate strategy or transaction that does not require a shareholder vote. For example, activists can apply pressure directly to managers to pursue business policies that favor their private interests, with other shareholders having no say in such decisions. Finally, free riding is an endemic problem. Even when a disinterested shareholder, such as a large mutual fund, holds a large enough block of shares to make it economically worthwhile to oppose an overreaching activist, the mutual fund may well decline to do so in the hope another large mutual fund may step in. None of this is to say that majority rule cannot be a serious impediment to minority shareholder "rent-seeking." But it is hardly a panacea. Ample room remains for expanded shareholder fiduciary duties to curb shareholder self-interested behavior.

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191. *See, e.g.*, Briggs, *supra* note 74, at 703-08 (discussing limited disclosure obligations of hedge funds).

CONCLUSION

Greed and selfishness are powerful forces, and they are no less powerful for shareholders than for corporate officers and directors.[192] Corporate law has historically relied on the fiduciary duty of loyalty to constrain greed and selfishness. In the case of officers and directors, these loyalty rules are well developed and regularly employed. The duty of loyalty has been applied sparingly to shareholders, however, and then only to controlling shareholders, primarily in freeze-out mergers and closely held corporations. Minority investors in public firms are viewed as free agents at liberty to use their influence as they please, including using it to serve their own personal economic interests.

This situation has arisen because minority shareholders in public firms have had, until recently, very little influence to either use or abuse. Moreover, it has been assumed that minority shareholders are motivated by a common and benign interest in improving corporate performance. But the corporate landscape is shifting under our feet. Dramatic changes in the markets, in business practices and institutions, and in corporate law, have given minority shareholders in public firms more power to influence corporate policy than they have ever enjoyed before. Activist investors, especially rapidly growing hedge funds, have not hesitated to employ this leverage with energy and ingenuity. In the process, serious schisms in shareholder interests have appeared, with more faults being revealed daily.

The corporate law rules of fiduciary duty are well suited to address the problem. This Article demonstrates this by proposing a reinterpretation of shareholder loyalty rules that treats all shareholders, controlling and minority alike, as subject to a latent duty of loyalty. That duty would be triggered whenever a shareholder successfully employs its shareholder status to promote a corporate action that gives it a personal, material economic benefit to the detriment or exclusion of other shareholders.

But to say that fiduciary duty law can control the downside of enhanced shareholder power is not the same thing as saying it is likely to do so. Existing case law provides a foundation on which courts can build a broader conception of shareholder duty than currently exists. Unless courts choose to build such a conception and apply loyalty duties beyond traditional paradigms, the doctrine of shareholder fiduciary duty will remain largely irrelevant both to the growing role of activists in corporate governance and to the debate over the wisdom of increasing shareholder power. We believe this would be an unfortunate waste of a valuable opportunity. For good or ill, the balance of power between

192. Indeed, they may be more powerful. Social context signals to corporate officers and directors that they are supposed to behave like selfless fiduciaries, and substantial evidence indicates that social context changes behavior. *See* Stout, *supra* note 18, at 1. Until courts expand shareholder fiduciary duties as we suggest, present social context encourages shareholders to act selfishly and opportunistically.

shareholders and managers in public firms is shifting toward greater "shareholder democracy." The reconception of shareholder fiduciary duties that we propose can do much to help ensure that this change is, indeed, a change for the better.