A LOOK AT BOARD DUTIES AND CONFLICTS FOR CORPORATIONS AND LLCS

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The world of corporate governance is experiencing a paradigm shift in recent years—with the movement away from a passive governing board and a rise in shareholder activism and shareholder democracy. This shift is marked by some inherent conflict-of-interest issues including (1) an increase in the number of constituent representatives on the board; (2) the rise of the influence of private equity; and (3) equity-interest owners demanding a right to nominate directors and managers. Courts, including in Texas and Delaware have generally avoided creating a unique theory of business organization for the limited liability company ("LLC") and choosing to analogize to the corporation and less frequently, the partnership. We include both Delaware and Texas in this article because of Delaware's continued status as a leading authority on corporate laws despite the fact that recent reports indicate that other states are gaining in favor.

I. TEXAS FIDUCIARY DUTIES

Texas has its own jurisprudence regarding director and manager fiduciary duties. In Texas, directors and managers have three broad fiduciary duties. These include the (1) duty of obedience; (2) duty of loyalty; and (3) duty of due care.

A. Duty of Obedience

The duty of obedience requires a director to avoid committing an ultra vires act which is to act beyond the scope and powers set forth in the articles of incorporation.[1] An ultra vires act, negligent or not, may be voidable under Texas law, but the director is not personally liable unless the action in question is also illegal.[2]

B. Duty of Care

In Texas, a director must handle her duties with such care as an ordinarily prudent person would use under similar circumstances.[3] The director must be diligent and informed and exercise honest and unbiased business judgment.[4] The business judgment rule is a defense to any perceived breach of the duty of care. The Fifth Circuit stated in *Gearhart* that, "the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an ultra vires act. If such a showing is not made, then the good or bad faith of the directors is irrelevant."[5] Since *Gearhart*, courts have held that the business judgment rule does not protect a breach of the duty of care that rises to the level of gross negligence.[6] In Texas, the test for gross negligence "contains both an objective and a subjective component."[7] Subjectively, a defendant must have actual awareness of the extreme risk created by his or her conduct.[8] Objectively, the defendant's conduct must involve an "extreme degree of risk," a threshold significantly higher than the objective "reasonable person" test for negligence.[9] A director's total abdication of her duties will fall within the definition of gross negligence.[10]

C. Duty of Loyalty

In Texas, the duty of loyalty has two components: (1) a director must act in good faith; and (2) a director must avoid self-dealing transactions and must act in the best interest of the corporation unencumbered by any pecuniary or other interest.[11] A director can be considered "interested" if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity;[12] (2) buys or sells assets of the corporation;[13] (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated;[14] or (4) transacts business in his director's capacity with a family member.[15]

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[1] *See Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (applying Texas law).

[2] *Id.*

[3] *Gearhart*, 741 F.2d at 719.

[4] *Id.*

[5] *Id.* at 723, n.9.

[6] *See, e.g., FDIC v. Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); *FDIC v. Schreiner*, 892 F. Supp. 869, 881 (W.D. Tex. 1995).

[7] *Wal-Mart v. Alexander*, 868 S.W.2d 322, 326 (Tex.1993).

[8] *Id.*

[9] *Id.*

[10] *Harrington*, 844 F. Supp. at 306, n.7.

[11] *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.);

[12] *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963).

[13] *Niagara Fire Ins. Co. v. Numismatic Co.*, 380 S.W.2d 830, 835 (Tex.Civ.App.—Fort Worth 1964, writ ref'd n.r.e.); *Brooks v. Zorn*, 24 S.W.2d 742, 749 (Tex.Civ.App.—Beaumont 1929, writ dism'd);

[14] *Reynold's-Southwestern Corp. v. Dresser Industries, Inc.*, 438 S.W.2d 135, 140 (Tex.Civ.App.—Houston [14th Dist.] 1969, writ ref'd n.r.e.);

[15] *Davis v. Nueces Valley Irrigation Co.*, 126 S.W. 4, 7 (Tex. 1910).

Transactions involving interested directors are not voidable unless it is unfair to the corporation.[16] The director may profit personally from a transaction so long as the terms are fair and the profit is incidental to the promotion of corporate interests.[17] A transaction is voidable if the director is found to have committed fraud, over-reaching, or waste of corporate assets.[18] A challenged transaction found to be unfair to the corporate enterprise may nonetheless be upheld if ratified by a majority of disinterested directors or the majority of the stockholders.[19] The interested shareholder is entitled to vote his or her shares in the ratification vote.[20]

D. Duty to Creditors

As a general rule, "Texas courts have held that the obligation between a borrower and a lender is not a fiduciary one."[21] It is unclear whether Texas will follow the trend of attributing fiduciary duties to creditors. An appellate court, in dicta, indicated that Texas may not attribute such fiduciary duties to corporate officers to the benefit of the creditors as the corporation approaches insolvency.[22] But once a corporation is insolvent, the so called "debtor-in-possession" has duties to creditors as a bankruptcy trustee.[23] A federal court ruled, applying Texas law, that corporate officers did owe fiduciary duties to creditors as the corporation entered "the zone of insolvency."[24]

E. Fiduciary Duties in Texas LLCs

The management authority of managers in a manager-managed LLC and members in a member-managed LLC undoubtedly carries with it similar responsibilities and duties. The Texas Business Organizations Code ("TBOC"), contains fiduciary duty provisions similar to the provisions found in the Delaware LLC Act.[25] The TBOC is silent as to the precise fiduciary duties of managers and members. But the TBOC acknowledges such duties and implies that a court may impose such duties. Pursuant to the TBOC, the company agreement of a LLC may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.[26] But the company agreement cannot eliminate the duty of loyalty as it relates to self-dealing transactions.[27] The legislature modeled the provisions addressing transactions involving interested governing persons of LLCs after the interested director provisions in the corporate context.[28] A duty of care is implied by provisions of the TBOC that protect governing persons and officers of a LLC if they in good faith and with ordinary care rely on information provided to them by specified persons.[29] The TBOC gives a LLC the ability to indemnify, advance expenses to, and insure managers, members, and other persons can be read to reflect some concern with liabilities to the LLC as well as liabilities to third parties.[30] In the absence of statutory law, the issue of fiduciary duties has been developed by common law.

There is a dearth of Texas case law addressing fiduciary duties of LLC members and managers. Texas courts have held that members in a member-managed LLC have fiduciary duties comparable to corporate officers and directors.[31] A bankruptcy court recently held, without much analysis, that in Texas a manager has fiduciary duties to the LLC similar to fiduciary duties of corporate directors to a corporation.[32] Another bankruptcy court held that managers and members have fiduciary duties to the LLC where the company

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[16] *International Bankers*, 368 S.W.2d at 577; *Henger v. Sale*, 365 S.W.2d 335, 340 (Tex. 1963); *Popperman v. Rest Haven Cemetery, Inc.*, 345 S.W.2d 715, 717 (Tex. 1961).

[17] *Gearhart*, 741 F.2d at 720.

[18] *Allen v. Wilkerson*, 396 S.W.2d 493, 508 (Tex.Civ.App.—Austin 1965, writ ref'd n.r.e.); *Mercury Life & Health Co. v. Hughes*, 271 S.W.2d 842, 849 (Tex.Civ.App.—San Antonio 1954, writ ref'd); *Duncan v. Ponton*, 102 S.W.2d 517, 523 (Tex.Civ.App.—Fort Worth 1937, no writ).

[19] *International Bankers*, 368 S.W.2d at 572; Tenison v. Patton, 67 S.W. 92, 95 (Tex. 1902).

[20] *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563, 568 (Tex.Civ.App.—Beaumont 1962, writ ref'd n.r.e.).

[21] *Williams v. Countrywide Home Loans, Inc.*, 504 F.Supp.2d 176, 192 (S.D.Tex. 2007).

[22] *See Prostok v. Browning*, 112 S.W.3d 876, 913 (Tex. App.—Dallas 2003), *judgment aff'd in part, rev'd in part*, 165 S.W.3d 336 (Tex. 2005).

[23] *Id.* (*citing Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 471 (1985))

[24] *See In re Brentwood Lexford Partners, LLC*, 292 B.R. 255, 272 (Bankr. N.D. Tex. 2003).

[25] *See* TEX. BUS. ORGS. CODE ANN. § 101.401.

[26] *Id.*

[27] *See id.* § 101.255.

[28] *See id.* §§ 21.418, 101.255.

[29] *Id.* §§ 3.102, 3.105.

[30] *Id.* § 101.402.

[31] *Bigham v. Southeast Texas Environmental, LLC*, 458 S.W.3d 650, 662 (Tex. App.—Houston [14th Dist.] 2015, no pet.); *Pinnacle Data Services, Inc. v. Gillen*, 104 S.W.3d 188, 198 (Tex. App.—Texarkana 2003, no pet.).

[32] *In re H & M Oil & Gas, LLC*, 514 B.R. 790, 815 (Bankr. N.D. Tex. 2014).

agreement provides a right to act on the LLC's behalf.[33] Texas courts have suggested that members do not necessarily owe fiduciary duties to each other simply because of their status as members.[34] These courts analogize the relationship of members to those of shareholders in a closely held corporation which do not have a formal fiduciary duty to each other.[35] But one court has found that members may have an informal fiduciary duty to other members based on their past relationship.[36] Texas courts do not impose a fiduciary duty lightly. A fiduciary duty is more than whether someone subjectively trusts another; rather a person must place "confidence in another in the sense demanded by fiduciary relationships because something apart from the transaction between the parties is required."[37]

Analogizing to either corporate or partnership law, a manager, or a member in a member-managed LLC, owes a duty of care when acting on behalf of the LLC.[38] The TBOC follows Delaware in providing that the LLC may expand or restrict duties and liabilities related to such duties.[39] The director's duty of care in the corporate context requires diligence and prudence in the management of the corporation's affairs.[40] Directors are protected by the business judgment rule, which is a reflection of courts' reluctance to second guess the good-faith business decisions of disinterested directors.[41] Courts applying Texas law may also look to partnership law in further defining the duty of care. In Texas, the duty of care in the partnership context is now expressly defined by statute.[42] A partner's duty of care is described in the statute as the duty to act "with the care an ordinarily prudent person would exercise in similar circumstances," but this language is qualified by the business judgement rule.[43] Courts are reluctant to impose any liability for mismanagement.[44]

Though the Texas statute does not directly address the exact nature of the duty of loyalty and what exactly is a "self-dealing transaction" as applied to managers and members of a LLC, a manager or managing member in an LLC will be held to a duty of loyalty similar to that owed by a director of a corporation or a general partner of a partnership absent a contrary provision in the company agreement.[45] A manager or managing member's duty of loyalty would include a duty not to compete with the LLC and not to usurp a business opportunity of the LLC as such aspects are recognized in both the corporate and partnership contexts.[46]

The TBOC has a provision addressing transactions between an LLC and a governing person (i.e., a manager of a manager-managed LLC or member of a member-managed LLC) or officer.[47] This statute is similar to the so-called "interested director" provision in the corporate context.[48] A transaction involving an interested manager in a manager-managed LLC or a managing member in a member-managed LLC must be fair to the LLC.[49] A transaction may escape-fairness scrutiny if either (1) a majority vote of disinterested members of the governing authority authorize the transaction based on knowledge of all material facts; or (2) the members of the company approve the transaction in good faith by vote of the members.[50] In determining whether a transaction was approved or ratified, interested governing persons may be counted for purposes of obtaining a quorum at the meeting at which a contract or transaction with an interested governing person is authorized.[51]

While it is obvious that managers in a manager-managed LLC and managing members in a member-

[33] *In re Lau*, 2013 WL 5935616, at *4 (Bankr. E.D. Tex. 2013).

[34] *Guevara v. Lackner*, 447 S.W.3d 566, 581 (Tex. App.—Corpus Christi 2014, no pet.) (holding an informal fiduciary relationship existed between three members of an LLC where each member had been friends described as a "relationship of trust and confidence.").

[35] *See id.*; *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.).

[36] *Bazan v. Munoz*, 444 S.W.3d 110, 118 (Tex. App.—San Antonio 2014, no pet.).

[37] *Am. Med. Intern., Inc. v. Giurintano*, 821 S.W.2d 331, 339 (Tex. App.—Houston [14th Dist.] 1991, no writ).

[38] *See In re H & M Oil & Gas, LLC*, 514 B.R. 790, 814–15 (Bankr. N.D. Tex. 2014) (applying Texas law).

[39] *Compare* DEL. CODE ANN. tit. 6, § 18-1101 *with* TEX. BUS. ORGS. CODE ANN. § 101.401.

[40] *See Gearhart*, 741 F.2d at 720.

[41] *See id.*

[42] TEX. BUS. ORGS. CODE ANN. § 152.206.

[43] *See id.* § 152.206(b), (c).

[44] *See Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 342 (Tex. App.—Dallas 1989, writ denied); *Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

[45] *See H & M Oil & Gas, LLC*, 514 B.R. at 814–15 (relying on Texas case law in the corporate context when describing the duty of loyalty applicable to an LLC manager).

[46] *See, e.g.*, *Johnson v. Buck*, 540 S.W.2d 393, 415 (Tex. Civ. App.—Corpus Christi 1976, writ ref'd n.r.e.) (applying duty of loyalty in the partnership context). *See, e.g.*, *International Bankers*, 368 S.W.2d at 570 (applying the concept of duty of loyalty in the corporate context).

[47] TEX. BUS. ORGS. CODE ANN. § 101.255.

[48] *Id.* § 21.418.

[49] *Id.* § 101.255(b)(2).

[50] *Id.* § 101.255(b)(1).

[51] *Id.* § 101.255(c).

managed LLC owe a duty of loyalty to the LLC itself, it is less obvious in what contexts fiduciary duties are owed to the members of a LLC. Texas courts seem reluctant to recognize that a fiduciary relationship exists between the members as a matter of law based only on their status as members of an LLC.[52] In 2014, the Texas Supreme Court rejected applying the doctrine of shareholder oppression in the corporate context reasoning that there is no statutory basis for such a claim and Texas has never recognized a common-law cause of action for "minority shareholder oppression."[53] A member who seeks to convince a court that the member is owed a duty by another member should analogize to a partnership rather than the corporate context to establish the existence of an informal fiduciary duty.[54]

Managers and Members in a Texas LLC have duties to creditors when the LLC is insolvent.[55] The duty extends to the officers of the LLC.[56]

II. DELAWARE FIDUCIARY DUTIES

A. Duty of Care

To adhere to its duty of care, a board of directors must inform themselves "prior to making a business decision, of all material information reasonably available to them."[57] The business judgment rule requires a director to have an informed basis for a decision.[58] The applicable standard of care is gross negligence.[59] If a director has an informed basis, a shareholder must raise sufficient doubt that the directors honestly and in good faith believed the action was in the best interests of the corporation.[60]

Delaware allows shareholders to adopt a provision in the certificate of incorporation to exculpate directors from personal liability for breaches of their duty of care, but not for duty-of-loyalty violations.[61] Shareholders of Delaware corporations have typically approved such provisions.[62]

B. The Role of the Business Judgment Rule

The business judgment rule has been a tenant of Delaware corporate law for well over one-hundred-fifty years.[63] Under the business judgment rule, a court will not overturn an action by the board of directors unless the board did not have a rational business purpose for the decision.[64] Courts do not impose liability on officers or directors for rational business decisions that over time prove unsuccessful.[65] In determining whether the business judgment rule applies, a court will presume that "in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company."[66] The proper standard for determining whether directors acted on an informed basis is gross negligence.[67] This means, at a minimum, the business judgment rule will not protect a board of directors that made an uninformed decision.[68]

The business judgment rule insulates a board of directors for several important policy reasons. First, potential directors may not serve on a board if they are subject to liability for bad business decisions. The business judgment rule encourages competent business leaders to serve as directors.[69] Second, the directors that serve on a board may be overly cautious in their decision making for fear of liability. Generally, potential profit is positively correlated with risk involved in a venture so it may not be in the best interest of shareholders or the

[52]*See Devon Energy*, 367 S.W.3d at 391.

[53]*Ritchie v. Rupe*, 443 S.W.3d 856, 877 (Tex. 2014).

[54]*See* TEX. BUS. ORGS. CODE ANN. § 152.204(a) ("A partner owes to the partnership, the other partners, and a transferee of a deceased partner's partnership interest as designated in Section 152.406(a)(2): (1) a duty of loyalty; and (2) a duty of care.").

[55]*In re Supplement Spot, LLC*, 409 B.R. 187, 204 (Bankr. S.D. Tex. 2009); *Brentwood*, 292 B.R. at 273.

[56]*Supplement Spot*, 409 B.R. at 204.

[57]*Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (citation omitted), *overr'd on other grounds by Gantler v. Stephens*, 925 A.2d 695 n.54 (Del. 2009).

[58]*See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

[59]*Van Gorkom*, 488 A.2d at 873.

[60]*In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275, 286 (Del. Ch. 2003).

[61]*Emerald Partners*, 787 A.2d at 90.

[62]*See* Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 692 (2009) ("After section 102(b)(7) was enacted, the shareholders of almost all Delaware corporations approved charter amendments containing these exculpatory provisions with full knowledge of their import—that directors would not have to pay money damages for duty of care violations, i.e., gross negligence.").

[63]*See* Justice Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 995 (1994).

[64]*Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

[65]*Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982).

[66]*Aronson*, 473 A.2d at 812 (internal citations omitted).

[67]*Van Gorkom*, 488 A.2d at 873.

[68]*Id.* at 872.

[69]Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 644 (1998).

economy to have overly cautious directors.[70] Shareholders generally prefer high-return projects accompanied by increased risk because they do not receive a return on investment until the corporation satisfies all other claims[71] Unlike directors, shareholders are insulated from the downside risk of corporate activity through limited liability.[72] In effect, shareholders push some of the risk of a decision to creditors of the corporation. An onerous liability standard will discourage directors from making the risky decisions that could enhance shareholder value substantially.[73] Finally, rational shareholders will prefer an erring director in a corporate decision than an erring judge.[74] An erring director is constrained in their decision by the competition whereas an unelected judge faces little constraints.[75]

C. Situations Requiring Heightened Scrutiny

A Delaware court will apply more strenuous scrutiny than the business judgment rule in rare situations.[76] First, increased scrutiny beyond the business judgment rule will apply in a sale or change of control.[77] In this context, a court will review the adequacy of the decision-making process and examine the reasonableness of the directors' action in light of the then-existing circumstances.[78] Second, a court will apply increased scrutiny to defensive measures in response to a threat to corporate control.[79] The directors have the burden of showing that after a reasonable investigation they determined in good faith that a particular threat warranted a defensive response.[80] If the defensive measures are not reasonable or proportional, a court will apply an entire-fairness review to the defensive measure.[81] Otherwise, the business judgment rule will apply.[82] The "reasonableness" standard for evaluating defensive measures reflects an intermediate standard of review between the business judgment rule and fairness review.[83] The rationale for this level of scrutiny is that directors "may be acting in their own self-interest to perpetuate themselves in office . . . ."[84]

The business judgment rule, by definition, does not apply to a situation where directors do not make a decision. An example is a situation where the board is responsible for monitoring management and the reporting process.[85] Compliance with the duty of care is the standard.[86] But similar to the business judgment rule, it is difficult to prove a breach of the duty of care. To show a breach of the duty of care for inadequate monitoring, a plaintiff in a derivative action must show (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took insufficient or no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in losses.[87]

D. Duty of Loyalty

In Delaware, the duty of loyalty mandates "that there shall be no conflict between duty and self-interest."[88] Directors "are not permitted to use their position of trust and confidence to further their private interests."[89] This statement has been refined to mean that directors cannot appear on both sides of a transaction nor expect to derive any personal financial benefit from the transaction.[90]

But a conflict of interest, by itself, does not result in a breach of the duty of loyalty per se. Rather, a court will analyze the transaction to determine whether it is "entirely fair" to the corporation and its stockholders. The Delaware Chancery Court has said the entire fairness standard is "Delaware's most onerous

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[70] *Joy*, 692 F.2d at 886.

[71] STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 115 (2008).

[72] *Id.*

[73] Jacqueline M. Veneziani, *Causation and Injury in Corporate Control Transactions: Cede & Co. v. Technicolor, Inc.*, 69 WASH. L. REV. 1167, 1191 (1994).

[74] *Id.*

[75] *Id.*

[76] *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 42 (Del. 1994) (discussing how an enhanced scrutiny is applied to self-dealing transactions, lockup agreements, and defensive measures).

[77] *Id.* at 45.

[78] *Id.*

[79] *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–56 (Del. 1985).

[80] *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48, 103 (Del. Ch. 2011).

[81] *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1377 n.18 (Del. 1995).

[82] *See Unocal*, 493 A.2d at 954–56.

[83] *See* Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 829 (1999).

[84] *Air Products*, 16 A.3d at 94.

[85] *See In re Caremark Int'l Inc., Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

[86] *Id.*

[87] *Id.*

[88] *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

[89] *Id.*

[90] *Aronson*, 473 A.2d at 812.

standard."[91] If entire fairness applies, a defendant must establish that the transaction in question was the product of both: fair dealing and fair price.[92] Whether an interested party subjectively and honestly believes a transaction was entirely fair to the corporation is insufficient to establish entire fairness.[93] The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction.[94]

To mitigate the harshness of the entire-fairness standard, Delaware adopted a safe-harbor provision whereby the interested transaction is "cleansed."[95] Under the provision, a transaction involving an interested director is not void or voidable if the transaction is approved, on a fully informed basis, either by a majority of the disinterested directors or by stockholders.[96] Otherwise, courts will evaluate the transaction pursuant to the entire-fairness standard.[97] The provision requires disclosure of all material facts relating to the director's interest or conflict and the transaction itself.[98] The Delaware Supreme Court has adopted the materiality test used by the U.S. Supreme Court for determining whether the disinterested board members or shareholders are fully informed. Information is material if a reasonable person would consider it important in deciding how to vote.[99] Approval by a disinterested majority of the board or disinterested stockholders may revive the strong presumptions of the business judgment rule.[100] The business judgment rule does not apply where a majority of the board is interested in the transaction.[101]

But there is one important exception to the "cleansing" effect of shareholder or director ratification of an interested transaction. When a controlling stockholder is on both sides of the transaction, the entire fairness standard applies regardless of approval by disinterested directors or stockholders.[102] A stockholder possesses control if the stockholder holds a majority of the voting power of the corporation or holds less than a majority stake but nonetheless possesses control over the decision making of the company.[103] A controlling stockholder will take on fiduciary duties to minority stockholders when a controlling stockholder exercises its control over the corporation.[104] The approval of disinterested directors or stockholders in a transaction involving a controlling stockholder will shift the burden of proving the transaction is unfair to the plaintiff.[105]

There is one important common-law exception to the imposition of the entire-fairness standard. The business judgement rule is the standard that governs mergers between "a controlling stockholder and its corporate subsidiary, where the merger is conditioned ab initio upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders."[106] Under Delaware law, corporations may not indemnify directors against personal liability for breaches of the duty of loyalty.[107]

The duty of loyalty may be implicated in connection with numerous types of corporate transactions, including, for example, the following: contracts between the corporation and directors or entities in which directors have a material interest; management buyouts; dealings by a parent corporation with a subsidiary; corporate acquisitions and reorganizations in which the interests of a controlling stockholder and the minority stockholders might diverge; usurpations of corporate opportunities; competition by directors or officers with the corporation; use of corporate office, property or information for purposes unrelated to the best interest of the corporation; insider trading; and actions that have the purpose or practical effect of perpetuating directors in office.[108]

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[91] *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 44 (Del. Ch.2013).

[92] *Cinerama, Inc. v. Technicolor, Inc. (Technicolor III)*, 663 A.2d 1156, 1163 (Del.1995).

[93] *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1145 (Del.Ch.2006).

[94] *See Kahn v. Tremont*, 694 A.2d 422, 429 (Del. 1997) ("Delaware law has long adhered to the principle that the controlling or dominant shareholder is initially allocated the burden of proving the transaction was entirely fair.").

[95] *See* DEL. CODE ANN. tit. 8, § 144.

[96] *Id.*

[97] *See id.*

[98] *Id.* § 144(a)(2).

[99] *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985).

[100] *See Gantler*, 965 A.2d at 713.

[101] *See Aronson*, 473 A.2d at 814–15.

[102] *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

[103] *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 991 (Del. Ch. 2014), *aff'd sub nom. Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015).

[104] *Calesa Assocs., L.P. v. Am. Capital, Ltd.*, No. CV 10557-VCG, 2016 WL 770251, at *10 (Del. Ch. Feb. 29, 2016).

[105] *Id.*

[106] *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014) (emphasis added).

[107] *See* DEL. CODE ANN. tit. 8, § 145(b).

[108] Byron F. Egan, *Fiduciary Duties of Corporate Directors and Officers in Texas*, Tex. J. Bus. L., Spring 2009, at 45, 61.

E. Duty to Creditors

Unless the corporation is insolvent or in the "zone of insolvency," directors do not owe corporate creditors extra-contractual duties. Once a corporation becomes insolvent, its officers and directors owe unsecured creditors a fiduciary duty.[109] The controlling shareholder(s) and director(s) of the debtor must maximize the value of the assets for payment of unsecured creditors.[110] Delaware has expanded the duty to apply when the corporation is in the "zone of insolvency."[111] But creditors of an insolvent corporation or creditors of a solvent corporation operating in the zone of insolvency, may not pursue a direct fiduciary-duty claim against the directors.[112] When a corporation is solvent, creditors have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value.[113] When a corporation is insolvent, however, its creditors take the place of the shareholders and have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.[114]

F. Fiduciary Duties in Delaware LLCs

Most courts are severely conflicted in how they interpret laws governing LLCs. Courts are tempted by the lure of analogizing general corporate law to LLCs. But that approach disregards the unique purpose of the LLC—to foster a flexible governance structure that supports the freedom of contracts. Most LLC statutes contain provisions concerning managers' and members' fiduciary obligations to the LLC and to each other.[115] Delaware's LLC Act[116] does not specify the duties owed by a member or manager. But it does provide for a default position "to the extent, at law or in equity" LLCs have "duties (including fiduciary duties)."[117] The legislative intent of the Delaware LLC Act is to give maximum effect to the principle of freedom of contract and to the enforceability of the LLC operating agreement.[118]

Generally, members who are not managers of manager-managed LLCs do not have fiduciary duties to the LLC or the other members solely by reason of acting in the capacity of a member.[119] The Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other, leaving the matter to be developed by the common law.[120] Delaware courts have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members in a member-managed LLC as owing each other the traditional fiduciary duties that directors owe a corporation.[121] In manager-managed LLCs, members generally do not have fiduciary duties except in limited circumstances.[122] If a duty arises from the members' contractual relationship, a contractual claim will preclude a fiduciary claim.[123]

In a manager-managed LLC, managers at least owe fiduciary duties to the company unless those duties are eliminated in the operating agreement. In *Auriga Capital Corporation v. Gatz Properties LLC,* the Delaware Chancery Court held that LLC managers owe fiduciary duties to the company when the agreement is silent concerning the existence of such duties under the principles of equity included in the Delaware LLC Act.[124] But the Delaware Supreme Court has said that the issue remains open and the Delaware Chancery

[109]*In re High Strength Steel, Inc.*, 269 BR 560, 569 (Bankr.D.Del. 2001).

[110]*Odyssey Partners, L.P. v. Fleming Co., Inc.*, 735 A.2d 386, 417 (Del.Ch.1999).

[111]*U.S. Nat. Bank Assoc. v. Timberlands Klamath Falls, L.L.C.*, 864 A2d 930, 941 (Del Ch 2004).

[112]*N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 100 (Del. 2007).

[113]*Id.* at 101.

[114]*Id.*

[115]*See* Callison and Vestal, *"They've Created A Lamb With Mandibles of Death": Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms*, 76 IND. L. J. 271 (2001) (discussing state fiduciary duty provisions).

[116]DEL. CODE ANN. tit. 6, §§ 18-101 to 18-1109.

[117]*Id.* § 18-1101(c).

[118]*Id.* § 18-1101(b).

[119]*See, e.g., Griffin v. Jones*, 170 F.Supp.3d 956, 961 (W.D. Ky. 2016) (member did not owe fiduciary duty to manager); *Inland Atlantic Old Nat. Phase I, LLC v. 6425 Old Nat., LLC*, 766 S.E.2d 86, 89 (Ga. 2015) (however, when agreement deleted specific management powers and duties to members, fiduciary duties can be owed).

[120]*See* DEL. CODE ANN. tit. 6 § 18-1104.

[121]*See Douzinas v. Am. Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149–50 (Del.Ch. 2006); *Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 153 (Del.Ch. 2004).

[122]*In re Regional Diagnostics, LLC*, 372 B.R. 3 (Bankr. N.D. Ohio 2007) (applying Delaware law); *In re South Canaan Cellular Investments, LLC*, 427 B.R. 85 (Bankr. E.D. Pa. 2010) (applying Delaware law).

[123]*See Solow v. Aspect Resources, LLC*, 2004 WL 2694916, at *5 (Del. Ch. 2004).

[124]*Auriga Capital Corp. v. Gatz Properties*, 40 A.3d 839, 849 (Del. Ch.), *judgment entered sub nom. Auriga Capital Corp. v. Gatz Properties, LLC* (Del. Ch. Feb. 23, 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

Court's original holding in Auriga was dicta.[125] Since Auriga, the Delaware Chancery Court has consistently held that LLC managers have default fiduciary duties to the company.[126] Because of perceived confusion as to the exact fiduciary duties of LLC managers, some states, such as California, have modified their state statutes to expressly state managers owe fiduciary duties to the company.[127]

Generally, unless the LLC agreement in a manager-managed LLC explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC.[128] Delaware law permits the complete elimination of fiduciary duties, including the duty of loyalty, but not the implied contractual covenant of good faith and fair dealing.[129] The Delaware LLC Act specifically allows LLC operating agreements to contain exculpatory provisions limiting managers' and members' liability for fiduciary breaches, except for liability arising from a "bad faith violation of the implied contractual covenant of good faith and fair dealing."[130] While somewhat analogous to Section 102(b)(7) of the Delaware General Corporate Code, which authorizes a corporation to adopt provisions limiting liability for a director's breach of the duty of care, Section 18-1101(e) of the Delaware LLC Act goes further. It allows broad exculpation of all liabilities for breach of fiduciary duties—including the duty of loyalty.[131] And Delaware courts generally will give effect to operating agreement establishing, limiting, and sometimes eliminating fiduciary duties so long as the language is clear.

Unlike in a Delaware corporation, a creditor may not sue derivatively on behalf of an insolvent LLC according to the literal terms of the Delaware LLC act.[132] Section 18-1002 limits standing to bring a derivative action "a member or an assignee."[133] Other provisions of the Delaware LLC Act support this reading. A LLC company agreement may "provide rights to any person, including a person who is not a party to the [company] agreement, to the extent set forth herein."[134] A potential creditor must bargain for the ability to bring a direct or derivative suit against the LLC.

III. STRUCTURING A CONFLICT FREE ENTITY

In a corporation, the board of directors are responsible for the "[t]he business and affairs of every corporation."[135] American corporations have always had a board of directors.[136] The board of directors is theoretically responsible for hiring day-to-day managers of the corporation, monitoring those managers, providing advice into the strategic direction of the corporation, and providing consent for significant business decisions. There is a litany of conflict-of-interest issues with this type structure. Sure, these "conflicts" are inherent and unavoidable given the structure of the corporation. But these conflicts are

[125] *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1218 (Del. 2012).

[126] *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 660 (Del. Ch. 2012). *See Kyle v. Apollomax, LLC*, 987 F.Supp.2d 519, 524 (D. Del. 2013) (citing *Zimmerman v. Crothall*, 62 A.3d 676, 702 n. 145 (Del. Ch. 2013)) (holding that when the company agreement silent, Delaware law imposes default fiduciary duties on managers).

[127] *See* CAL. CORP. CODE §17153 ("The fiduciary duties a manager owes to the LLC and to its members are those of a partner to the partnership and to the partners of a partnership."). *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P*, 2000 WL 1476663, at *10 (Del.Ch. Sept.27, 2000).

[128] *But see Tuckerbrook Alternative Investments, LP v. Banerjee*, 2008 WL 2356349 (D. Mass. 2008) (holding that managing members in Delaware LLC have duties to one another despite some language in the operating agreement suggesting the contrary).

[129] *See, e.g., Zimmerman*, 62 A.3d at 703 (recognizing that LLC agreement "restricted" fiduciary duties owed by LLC management by setting a general standard for fiduciary conduct and by allowing directors to engage in transactions with LLC subject to certain requirements, including "fairness").

[130] DEL. CODE ANN. tit. 6, § 18-1101. *See Kelly v. Blum*, 2010 WL 629850, at *4 (Del. Ch. 2010) (applying DEL. CODE ANN. tit. 6, § 18-1101(e)); *Pappas v. Tzolis*, 87 A.D.3d 889,891 932 N.Y.S.2d 439, 443 (1st Dep't 2011) (explaining that the duty of good faith does not permit a member to engineer the sale of the LLC's largest asset without informing other members notwithstanding a provision in operating agreement of the Delaware LLC allowing member to pursue business opportunities for his own benefit); *see also Merrill v. Crothall-Am., Inc.*, 606 A.2d 96, 101 (Del. 1992) (interpreting a party's lack of good faith as "bad faith" as breach of the covenant); Restatement (Second) of Contracts § 205 cmt. a (1981) ("The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context . . . ; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness.").

[131] DEL. CODE ANN. tit. 6, § 18-1101 (emphasis added).

[132] CML V, LLC v. Bax, 6 A.3d 238, 242 (Del. Ch. 2010).

[133] *Id.*

[134] DEL. CODE ANN. tit. 6, § 18-101(7).

[135] DEL. CODE ANN. tit. 8, § 141(a).

[136] *See* Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89, 108 (2004).

significant and should give courts pause to blindly analogize LLCs to general corporate law or partnership law.

One inherent conflict with the current structure of the board of directors in a corporation is board compensation. The business judgment rule does not apply to situations where a director is engaged in self-dealing. A shareholder can argue that directors are interested in keeping their lucrative position on the board that influence them into making decisions that will perpetuate themselves in office. Generally, the receipt of customary directors' fees do not implicate a breach of the duty of loyalty per se.[137] Conflicts of interest do not arise because the directors have an interest in maintaining their office, even if they are compensated generously for their service.[138] Rather, a shareholder will have the almost insurmountable burden of proving that a board receives exorbitant fees representing a large percentage of their income that they wish to protect. This depends on the subjective wealth and business interest of each director. A court will review the materiality of the alleged interest of each individual director and only conclude that the board was conflicted if the impartiality of a majority of the directors is impugned.

Another inherent conflict with the corporate structure is that shareholders are generally prevented from intervening to adopt changes in the company's basic governance arrangements or to make major business decisions. When left to the board of directors, they have an inherent personal and professional conflict of interest to perpetuate their lucrative position on the board regardless of the actual effect an action or inaction may have on shareholders. A great example is the recent battle over proxy access in the public company context and the threat of constituent directors who tend to represent the particular interest of a financial or private equity sponsor.

A LLC is a structure created by contract, namely, the operating agreement.[139] The members of the company should be able to govern the entity using any method they want so long as the structure is clearly set forth in the company agreement. The LLC is one of the few entity structures whereby corporate constituents would be permitted to enforce their rights against the corporation and management directly. The LLC would permit the formation of a so called investor board whereby the governing body could be comprised entirely of stakeholders that could effectively monitor management and make major business decisions.

One problem with the corporate structure is that smaller companies and startups may not be able to find qualified independent directors to serve on the board because of the risk associated with the fiduciary duties of a corporation. To attract qualified businesspeople to the startup entity, it should choose to organize as a LLC and eliminate duties to the maximum extent. Of course, a LLC will not shield a manager for potential liability since many courts are mistakenly analogizing a LLC to a corporation in applying fiduciary duties. A small minority of courts have appropriately confined the discussion of duties or standards to the governing LLC statute and/or operating agreement.[140] But the failure to consider a LLC as its own unique theory of business organization represents a lost opportunity for LLCs to fill a distinct niche in business organizations law—that of a contract between sophisticated parties to attract the best businesspeople to the company. Organizers cannot waive conflict of interest issues with a LLC because courts may not adhere to the operating agreement, choosing to impose fiduciary duties to managers or members of a LLC analogized from corporate law. By holding a manager of a LLC to the fiduciary duties of a corporation, it will make it difficult for sophisticated parties to legitimately represent the interest of a constituency.

Delaware has taken a step in the right direction. They have codified in its LLC act that the duty of loyalty may be eliminated via the operating agreement. But the statute contains an interesting exception. Even if the duty of loyalty is eliminated in the operating agreement, a member or manager may not adhere to the "implied contractual covenant of good faith and fair dealing."[141]

IV. CONSTITUENT DIRECTORS AND MANAGERS

Constituent directors—directors who are appointed by a particular group or shareholder and seen as beholden to their interests—have always presented conflict-of-interest issues. This issue has been exacerbated in recent years by the rise of shareholder activism. Shareholder activists acquire a significant equity interest in a company in an attempt to change management with the goal of increasing the value of their investment. But activist shareholders are rather controversial. In the public company context, activist

[137] *See Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) ("The only averment permitting such an inference [of financial interest] is the allegation that all GM's directors are paid for their services as directors. However, such allegations, without more, do not establish any financial interest.").

[138] *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1074 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

[139] *See* TEX. BUS. ORGS. CODE ANN. § 101.052.

[140] *See, e.g.*, *Lynch Multimedia Corp. v. Carson Commc'ns, L.L.C.*, 102 F.Supp.2d 1261, 1264 (D. Kan. 2000); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 709 (Bankr. E.D. Va. 2000).

[141] DEL. CODE ANN. tit. 6, § 18-1101(e).

shareholders have been known to broadcast plans to change the target company.[142] Some have even leaked board disagreements to the media.[143] Despite recent performance woes for some activist shareholders, shareholder activism will continue. But traditional corporate law has not caught up to shareholders taking an active role in the management of a corporation. Activist shareholders present interesting conflict-of-interest issues when the interest of the activist appears to diverge from that of the company.

Activist shareholders usually have enough of an equity interest to influence the board to appoint, or at least nominate, its own directors. These constituent directors are often seen as beholden to his or her sponsor. Activist shareholders are not the only "constituent directors." A director may be appointed by a large shareholder, such as a private-equity firm to represent its unique interests. A director may also serve the interests of non-shareholder constituencies such as employees, suppliers, or creditors. For example, a constituent representing a large union may focus on the interest of employees who may have unique concerns. Employees may not want to shutter a particular factory in a particular location despite it being in the best interest of the corporation. This is not limited to the corporate context. The LLC board of managers can also have "constituent mangers." Many startups are structured as a corporation or a manager-managed LLC. Private equity firms may have a constituent representative on the board to monitor the firm's investment.

But these constituent directors cannot serve two masters.[144] If they are actually beholden to the interest of the activist shareholder without considering the interest of the entire company they will certainly breach the duty of loyalty. Yet, there are several constraints on the ability of a constituent director to solely represent its constituency.

Directors of public companies must be "independent" as defined by the particular exchange rules.[145] The independence rules serve as protection against an interested constituency director that has a relationship with the company, such as labor-union official. The board of directors must affirmatively determine that a director has no material relationship with the listed company.[146] Independent directors must constitute a majority of the board.[147] Constituent representatives that are not independent cannot serve on important committees such as the audit committee, compensation committee, and nominating committee.[148] Depending on the committee, independence tests may be more strenuous.[149] It is difficult for a non-independent director to drastically affect board policy if they do not serve on an important committee. For example, the audit committee is given exclusive authority to act on behalf of the board while the nominating and compensation committee make recommendations to the entire board.[150]

Assuming constituency directors are independent, there is a chance that the activist investor's interest aligns with the company—both want to increase the long-term value of the company. A director can serve a constituency and other investors if they believe the "long-term profitability of the corporation generally depends on meeting the fair expectations of such groups."[151] Constituent representatives can typically make such an argument. For example, a board member of an oil and gas exploration and production company can make a well-reasoned argument that operating in an environmentally sustainable manner will increase long-term financial value. Although it might appear the board member is representing a particular constituency, there are many different paths to long-term profitability. Board members are liable if they openly serve a constituency without articulating a path to long-term success. Board members are potentially liable for breach of fiduciary duty if they fail to maintain an undivided loyalty to all common shareholders.[152] This liability serves as a deterrent. In the corporate context, the Delaware Supreme Court has held that directors owe

[142]Darden Restaurants Inc., Additional Definitive Proxy Soliciting Materials Filed by Non-Management and Rule 14(a)(12) Material (Form DFAN 14A) at 1 (Apr. 1, 2014), *available at* https://www.sec.gov/Archives/edgar/data/940944/000092189514000699/ex991dfan14a06297125_033114.pdf.

[143]Bill Ackman's August 9 Letter JCPenney's Board, CNBC, (Aug. 9, 2013), *available at* https://www.cnbc.com/id/100952339.

[144]Matthew 6:24.

[145]*See* NASDAQ Stock Market Listing Rules, Rule 4350(c); N.Y. Stock Exch., Inc., Listed Company Manual § 303A.01. The Sarbanes–Oxley outlined director independence rules, but the NYSE and the NASDAQ instituted more strenuous rules.

[146]N.Y. Stock Exch., Inc., Listed Company Manual § 303A.02.

[147]*See id.*

[148]*See id.*

[149]*See id.* (requiring a board of directors to determine "consider all factors specifically relevant to determining whether a director has a relationship to the listed company" including transactions with the company or its subsidiaries).

[150]*See id.* § 303A.

[151]ALI Principles of Corporate Governance: Analysis and Recommendations § 2.01 cmt. f (1994).

[152]Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U.L. REV. 309, 311 (2013). Unlike common shareholders, preferred shareholders

fiduciary duties to "the corporation and its shareholders."[153] In Delaware, this means a director must consider all common shareholders above any concern for another constituency.[154]

A board member may consider the interests of other constituencies.[155] But there are limits. A constituency director must articulate how their constituents' goals align with the interests of the corporation to avoid a shareholder claim of breach of fiduciary duties.[156] A constituency has other means of protecting their interests, such as contractual provisions which further limits a director's ability to consider their interests.[157] Therefore, the constituency director must walk a tightrope to serve two masters—their constituency and the common shareholders. It is possible to serve two masters if the constituency director persuades the other directors that its sponsors' interests align with the interests of the common shareholders.[158] Otherwise, the constituency director will expose themselves to a shareholder derivative action for breach of fiduciary duty.

Delaware law permits constituent directors to disclose information to their sponsors so long as they do so in a manner that is consistent with their fiduciary duties.[159] But a constituent director may breach their duty of loyalty, in addition to any contractual obligations, if they act upon confidential information. Directors may not use their board position to further their own pecuniary interest.[160] In Hollinger International, Inc. v. Black,[161] the court held that the defendant violated his fiduciary duty of loyalty to the plaintiff because he "improperly us[ed] confidential information belonging to [Hollinger] International to advance his own personal interests and not those of International, without authorization from his fellow directors."[162] A director and shareholder could still use their position to inspect the books of the company. The Delaware courts have held that directors making a proper request to inspect the books are subject to their fiduciary duties.[163] A fiduciary may not disclose proprietary information to third parties.[164]

It is unclear how courts in either Texas or Delaware will see the role of constituency managers in an LLC and to what extent may such managers openly represent the interest of the constituency. Although it is tempting for a court to analogize fiduciary duties of LLC managers to that of corporate directors, it is likely these courts will say that a manager may openly represent a constituency because such act does not rise to the level of self-dealing. Unlike corporate law, the operating agreement can eliminate the duty of loyalty to some extent. But the duty of loyalty will apply to a self-dealing transaction regardless of what the operating agreement says. Serving a constituency is certainly not a self-dealing transaction even though the manager is appointed by the constituency. As the courts have said in the proxy-access context,[165] the possibility of perpetuation of membership on a board and board compensation does not create a conflict of interest unless the board member receives a significant and substantial percentage of their income from their board position.

But what does preclude openly serving a constituency under the façade of a violation of the duty of loyalty? A board constituted entirely of constituents, such as a shareholder, employee, and creditor representatives, would benefit a company by enhancing the board's governance function. A constituency board

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are only entitled to contractual protections. *See generally Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 942 (Del. 1979) (opining that preferred shareholders' participation rights are limited to those provided in the certificate of incorporation).

[153]*See Gheewalla*, 930 A.2d at 99 ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders."); *Revlon, Inc. v. MacAndres & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) ("[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.").

[154]*See Unocal*, 493 A.2d at 955 ("[O]ur analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders.").

[155]*See id.* (stating that in responding to a takeover bid, directors may consider, among other things, "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally").

[156]E. Norman Veasey & Christine T. DiGuglielmo, *How Many Masters Can A Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 772 (2008).

[157]*Id.* at 767.

[158]*Id.* at 772.

[159]*See, e.g.*, *Kalisman v. Friedman*, C.A. No. 8447-VCL, 2013 WL 1668205, at *6 (Del. Ch. Apr. 17, 2013) (discussing the question of whether sharing was permitted when the parties had failed to address the matter, holding that, "[w]hen a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director.").

[160]*Guth*, 5 A.2d at 510.

[161]844 A.2d 1022 (Del. Ch. 2004).

[162]*Id.* at 1061–62.

[163]*See Kortum v. Webasto Sunroofs, Inc.*, 769 A.2d 113, 121 (Del. Ch. 2000).

[164]*See id.* at 121 n. 17.

[165]*See* Section F *infra*.

will likely have plenty of disagreements—but they are the disagreements that an actual board is expected to consider and mediate. Most importantly, it will enhance the board's monitoring responsibility by eliminating conflicts of interest. Today, many board members are beholden to management because they do not want to balkanize the board and potentially be removed from their board seat. Under a constituency board, the designated shareholder representatives have no desire to curry favor with management.

V. PRIVATE EQUITY INVESTMENT & BOARD REPRESENTATION

Private-equity firms often face interesting conflict-of-interest issues. Typically, these firms make a significant investment into a company or startup in exchange for equity ownership that comes with rights to board representation. This is usually done through ownership of preferred stock or, in the case of a manager-managed LLC, a different class of equity. The preferred stock or separate class of equity ownership will give the holder the ability to nominate board members. But there are situations where the interest of the preferred stock, held by the private-equity firms, and the common stock held by ordinary investors may conflict. If the directors decide to sell, wind down, or invest in a company, the preferred stockholders may fare better than the common, and if at least half of the board consists of principals of the private-equity firm or otherwise has a special pecuniary interest, a conflict may exist. In these situations, the onerous "entire fairness" standard of review may apply, and the directors must prove that they engaged in a fair process and achieved a fair result.

Some startups, whether organized as a corporation or a manager-managed LLC, will likely have problems raising capital at some point. When private-equity firms (often referred to as "venture-capital firms" when investing in startups) make an early and sizable investment into the company, the firms want and usually receive a "constituent director" or "constituent manager." As a large equity-interest owner, these private equity firms may be asked for additional capital infusions. But there is an inherent conflict of interest—the representatives of the private equity firm sits on the board of directors of the company which will negotiate against the interests of the firm as a lender.[166] And these firms may also infuse capital into the company through equity issuances that will dilute other shareholders. Recent Delaware cases have addressed this particular conflict of interest. In *Carsanaro v. Bloodhound Technologies, Inc.*[167] five software developers, including Bloodhound's founder held common stock.[168] After Bloodhound raised its initial rounds of venture capital financing, the venture capitalists obtained control of the Company's board of directors.[169] Once the venture capitalist obtained control of the board, the constituent directors financed the company through self-interested and highly dilutive stock issuances to the venture capital firm.[170] The plaintiffs alleged that the venture-capital funds breached their fiduciary duties. In its decision denying the directors' motion to dismiss the litigation, the court was critical of the board for, among other things, obtaining stockholder consent to approve financing-related charter amendments without providing the actual charter amendments to a "swing-vote" stockholder who did not have insider information but whose vote was critical.[171] The court also was critical of a management incentive plan adopted in connection with the sale of the company that consumed 18.87% of the deal consideration, or $15 million, as compared to the $100,000 in proceeds paid to common stockholders.[172]

Private equity firms face another potential conflict of interest—conflicts involving controlling stockholders. The Delaware courts have held in multiple cases that a conflict exists, and the entire fairness standard of review will apply, if a company engages in a transaction with a controlling stockholder.[173] Fortunately, a court may evaluate the board if the transaction is negotiated and approved by a committee of the independent members of the board or where a majority of the disinterested stockholders properly approve a transaction.[174]

VI. PROXY ACCESS: A CONFLICT OF INTEREST?

In public corporations, proxy access is one of the most controversial subjects in corporate governance over the past decade.[175] Proxy access refers to a set of

[166] *See* Matthew P. Quilter, Austin Choi, and Sayre E. Stevick, Duties of Directors: Venture Capitalist Board Representatives and Conflicts of Interest, 1312 PLI/Corp 1101, 1103–04 (2002).

[167] 65 A.3d 618 (Del. Ch. 2013).

[168] *Id.* at 628.

[169] *Id.*

[170] *Id.*

[171] *Id.* at 647.

[172] *Id.* at 641–43, 665.

[173] *Kahn*, 88 A.3d at 644.

[174] *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 36 (Del. Ch. 2013).

[175] *See, e.g.*, Motion for Stay of Proxy Access Rules, 75 Fed. Reg. 56,668 (Sept. 29, 2010) ("Few issues in corporate governance have generated more disagreement or stronger passions.").

rules designed to enable shareholders to nominate their own candidates to the board of directors by eliminating or reducing barriers in the proxy-solicitation process.[176] Today, if a board declines to institute a shareholder proxy-access proposal, the business judgment rule protects that decision. However, in the future a stricter standard of scrutiny may be applied in light of the potential conflict of interest requiring a board of directors to articulate specific reasons for a departure or complete disregard of a shareholder proxy access proposal approved by a majority of shareholders.

A. History of Proxy Access

The current battle of proxy access dates back to 2009 when the Securities and Exchange Commission ("S.E.C." or "Commission") proposed Exchange Act Rule 14a–11, the federal proxy-access rule.[177] The proxy-access rule approved by the Commission allowed shareholders to nominate directors if certain prerequisites were satisfied: a corporation's governing documents do not prohibit shareholders from nominating a candidate for election as a director, the nominating shareholder owned at least three percent of the voting power of a corporation's securities, and the shareholder continuously held the securities for at least three years.[178] Shareholders could aggregate their shares with an unlimited number of other shareholders to meet the three-percent ownership threshold.[179]

Two organizations successfully challenged the rule alleging proxy access would impose economic hardship upon companies.[180] They reasoned that the number of contested board seats would rise significantly under the rule, thus increasing the cost to the company for solicitation and campaigning for company-nominated candidates.[181] The Commission chose not to appeal the decision.[182]

B. Shareholder Proxy Access Proposals

Although the S.E.C. has vacated federal proxy access, shareholders remain steadfast in attaining the ability to nominate their own directors. Institutional investors have submitted binding[183] and non-binding proxy access proposals at many companies.[184] Most of the proposals are precatory, meaning the proposals are non-binding, because binding proposals require careful and tailored drafting that cannot exceed five-hundred words.[185] And a binding proxy-access proposal may contravene Delaware state law.[186]

In 2015, shareholders voted on eighty-four binding and non-binding proxy-access proposals with forty-nine non-binding proposals receiving majority shareholder approval.[187] The New York City Comptroller submitted seventy-five proxy-access proposals which targeted companies with lack of diversity on the board, significant opposition to executive compensation, and contributions to climate change.[188] These proxy-access proposals for all seventy-five companies have the exact same terms.[189] The proposals are non-binding, and each call for a shareholder right to nominate their own directors if the shareholder has owned or beneficially owned three percent of the company continuously for at least three years.[190]

Shareholders are able to bring proposals, including proxy-access proposals, through S.E.C. Rule 14a-

[176]Facilitating Shareholder Director Nominations, Securities Act Release No. 33,9136, Exchange Act Release No. 34,62764, Investment Company Act Release No. 29384, 75 Fed. Reg. 56668, 56743-48 (Sept. 16, 2010) (to be codified at 17 C.F.R. pt. 200, 232, 240, 249).

[177]*See* Facilitating S'holder Director Nominations, 74 FR 29,024-01 (proposed June 18, 2009).

[178]*See* Facilitating S'holder Director Nominations, 75 FR 56,668-01 (Sept. 16, 2010).

[179]*See id.*

[180]*Bus. Roundtable*, 647 F.3d at 1146.

[181]*Id.* at 1150.

[182]Press Release, SEC Chairman Mary L. Schapiro, Statement by SEC Chairman Mary L. Schapiro on Proxy Access Litigation (Sept. 6, 2011), https://www.sec.gov/news/press/2011/2011-179.htm.

[183]*See, e.g.* The Western Union Co., Definitive Proxy Statement (Form DEF 14A), at 73–74 (Apr. 10, 2012) (binding proxy-access proposal). The binding proposal for The Western Union Company failed to receive majority support. *See* The Western Union Co., Regulation FD Disclosure (Form 8-K) at 1 (May 25, 2012).

[184]*See, e.g.* Exxon Mobil Corp., Definitive Proxy Statement (Form DEF 14A) at 64–65 (Apr. 14, 2015). The precatory proposal for Exxon Mobile Corporation failed to receive majority support. *See* Exxon Mobil Corp., Regulation FD Disclosure (Form 8-K) at 3 (Jun. 6, 2015) (noting the proxy-access proposal received 49.4% of the vote).

[185]17 C.F.R. § 240.14a-8 (2014).

[186]DEL. CODE ANN. tit. 8, § 141(a).

[187]Holly J. Gregory, *Is Proxy Access Inevitable?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 3, 2015), http://corpgov.law.harvard.edu/2015/08/03/is-proxy-access-inevitable/.

[188]*Boardroom Accountability Project*, N.Y.C. COMPTROLLER, https://comptroller.nyc.gov/services/financial-matters/boardroom-accountability-project/overview/ (last visited Sept. 4, 2017).

[189]*Id.*

[190]*Id.*

8(i)(1).[191] This rule requires a company to include shareholder proxy-access proposals. But the rule has many procedural restrictions. A company may exclude a shareholder proposal from its proxy materials if the shareholder fails to present timely and adequate proof that they own the corporation's securities.[192] And a company may exclude proposals longer than 500 words.[193]

C. Board of Directors' Resistance to Proxy Access

Unsurprisingly, corporate directors often oppose institutional access to the proxy. In those instances where a company supports proxy access, it generally does not support shareholder proposals as written. Those directors sometimes use the argument that shareholder access to the ballot will discourage competent directors from serving because they could see an election battle every year thereby risking public rejection and embarrassment.[194] Another reason for their objection is the potential for annual turnovers and the distractions to the board and management which keeps them from their primary task of running the enterprise.

But what recourse do shareholders have, if any, when a board alters or disregards a shareholder-approved advisory proposal? Shareholders have claimed a board of directors breached their fiduciary duties after declining to follow a precatory vote. The "say-on-pay" advisory votes are an example. The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2012[195] requires a shareholder advisory vote regarding executive compensation at least once every three years.[196] The vote does not "create or imply any change to the fiduciary duties of such issuer or board of directors" nor does it "create or imply any additional fiduciary duties for such issuer or board of directors."[197] Although non-binding, the S.E.C. requires companies to disclose in future proxy statements whether the company considered the results of the advisory vote.[198] Shareholders have brought derivative suits when a board disregards a negative say-on-pay advisory vote alleging, inter alia, breach of fiduciary duty,[199] and unjust enrichment.[200] To date only one court has ruled that a negative say-on-pay vote overcomes the business judgment rule and states a claim for breach of fiduciary duty.[201] Other courts have held that a negative say-on-pay advisory vote is insufficient to rebut the business judgment presumption.[202] It appears that a negative advisory vote can the basis for a cause of action because a board must make a business decision about whether to follow a shareholder-approved by-law. But the business judgment rule is an obstacle to a successful claim. Before a court can evaluate the fairness of the decision, shareholders must show that the board is not entitled to the deferential business judgment rule. The issue becomes whether an advisory vote on proxy access is analogous to a negative say-on-pay vote. Even if this is found to be true with the protection of the business judgment rule, it is hard to imagine that this will be the successful basis for an action alleging breach of fiduciary duties.

If a board ignores a proposed shareholder by-law that directly affects the director's procedure for election, such as proxy-access proposals, courts have recognized that there is an inherent conflict of interest instead of blindly following the business judgment rule. Directors "are not permitted to use their position of trust and confidence to further their private interests."[203] This statement has been refined to mean that directors cannot appear on both sides of a transaction nor expect to derive

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[191] *See* 17 C.F.R. § 240.14a-8.

[192] *See* 17 C.F.R. § 240.14a-8(b)(2). The proof-of-ownership requirement is necessary because most investors are not recorded in the company's records. Rather, the securities are beneficially held by the investors in the name of an institutional investor. This is commonly referred to as being held in "street name."

[193] *Id.* § 240.14a-8(d).

[194] Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U.L. REV. 37, 75 (1990); *see also* Anadarko Petroleum Co., Definitive Proxy Statement (Form DEF 14A) at 84 (Mar. 23, 2015) ("[T]he prospect of routinely standing for election in a contested situation may deter highly qualified individuals from Board service.").

[195] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[196] 15 U.S.C. § 78n-1.

[197] 15 U.S.C. § 78n-1(c).

[198] 17 C.F.R. § 229.402(b).

[199] *See Raul v. Rynd*, 929 F.Supp.2d 333, 343 (D. Del. 2013) (dismissing a claim for breach of fiduciary duty following negative say-on-pay vote).

[200] *See NECA-IBEW Pension Fund ex rel. Cincinnati Bell, Inc. v. Cox*, 1:11-CV-451, 2011 WL 4383368, at *4 (S.D. Ohio Sept. 20, 2011) (recognizing a claim of unjust enrichment following negative say-on-pay vote).

[201] *See id.*

[202] *Gordon v. Goodyear*, 2012 WL 2885695, at *10-11 (N.D. Ill. 2012); *Laborers' Local v. Intersil*, 2012 WL 762319, at *8 (N.D. Cal. 2012); *Plumbers Local No. 137 Pension Fund v. Davis*, 2012 WL 104776, at *7–*8 (D. Or. 2012), report and recommendation adopted, 2012 WL 602391 (D. Or. 2012); *Iron Workers Local No. 25 Pension Fund ex rel. Monolithic Power Systems, Inc. v. Bogart*, 2012 WL 2160436, at *4 (N.D. Cal. 2012); *Teamsters Local 237 Additional Sec. Ben. Fund v. McCarthy*, 2011 WL 4836230 (Ga. Super. Ct. 2011); *Raul v. Rynd*, 929 F. Supp. 2d 333, 344 (D. Del. 2013).

[203] *Guth*, 5 A.2d at 510.

any personal financial benefit from the transaction.[204] The business judgment rule does not apply to situations where a director is engaged in self-dealing.[205] A shareholder can make a case for breach of duty of loyalty when a board fails to implement proxy access after passage of a binding or precatory proposal. A shareholder can argue that directors are self-interested in keeping their position on the board that they choose to ignore proxy access and shutting out any potential competitor.

Although directors may have good reasons for disregarding the shareholders, courts should place the burden on directors to substantiate their corporate-governance decisions. The right to elect directors is a shareholder right[206] and a board of directors should carefully evaluate any decision expanding or restricting the right of shareholders to vote for directors.

[204]*Aronson*, 473 A.2d at 812.

[205]*Id.*

[206]DEL. CODE ANN. tit. 8, § 211(b).