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### Reconsidering the Evolutionary Erosion Account of Corporate Fiduciary Law

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# RECONSIDERING THE EVOLUTIONARY EROSION ACCOUNT OF CORPORATE FIDUCIARY LAW

William W. Bratton<sup>†</sup>

*This Article reconsiders the dominant account of corporate law’s duty of loyalty, which asserts that the courts have steadily relaxed standards of fiduciary scrutiny applied to self-dealing by corporate managers across more than a century of history—to the great detriment of the shareholder interest. The account originated in Harold Marsh, Jr.’s foundational article, Are Directors Trustees? Conflicts of Interest and Corporate Morality, published in The Business Lawyer in 1966. Marsh’s showing of historical lassitude has been successfully challenged in a recent book by Professor David Kershaw. This Article takes Professor Kershaw’s critique a step further, asking whether the evolutionary erosion account continues to exert normative power in today’s corporate governance context. The answer is that it does not, a result that obtains even though erosion of the standards that courts apply to management self-dealing has continued unabated ever since Marsh published in 1966, and even though there is no reason to think that management self-dealing benefits the shareholder interest. The result follows from the operation of the corporate governance system, which has assimilated and redeployed the erosion account’s motivating insight that officer and director self-dealing transactions do not make cost-benefit sense from the shareholder point of view. Regulation backs up the norm of aversion. Disclosure rules make self-dealing transparent to shareholders, who have no reason to like self-dealing and who now stand ready and able to register their preferences regarding such matters in corporate boardrooms. At the same time, the requirement of a majority independent board makes self-dealing transactions by board members highly inconvenient, because self-dealing undercuts independence. The practice reflects all of this, as shown by reference to hand-collected datasets of self-dealing transactions at publicly-traded companies and of litigation in respect of self-dealing transactions in the Delaware Chancery Court. The classic self-dealing transaction,*

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*although still a focal point of academic discourse on corporate fiduciary law, does not matter all that much in real world companies with dispersed shareholders. It is no longer an unsolved problem stemming from separated ownership and control.*

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## INTRODUCTION

This Article reconsiders the dominant account of corporate law’s duty of loyalty, referred to here as the “evolutionary erosion account.”<sup>1</sup> The account asserts that the courts have steadily relaxed standards of fiduciary scrutiny applied to self-dealing by corporate managers across more than a century of history, to the great detriment of the shareholder interest. The account originated in Professor Harold Marsh, Jr.’s foundational article, *Are Directors Trustees? Conflicts of Interest and Corporate Morality*, published in 1966.<sup>2</sup> Marsh’s showing of historical lassitude complemented the then-prevailing account of a corporate governance system impaired by separated ownership and control and a legal system enervated by charter competition. The evolutionary erosion story made perfect sense in that context—just as the legislatures competing for corporate charters relaxed statutory constraints on managers during the late nineteenth and early twentieth centuries, so did the judiciary follow suit, catering to managers by allowing them to self-deal. Shabby compromises followed for corporate fiduciary law. The erosion account had a clear and powerful normative implication: standards of conduct and review needed to be retightened to break the pattern of management advantage-taking.

Marsh’s presentation of the late nineteenth and early twentieth century cases has been forcefully challenged in a recent book by Professor David Kershaw.<sup>3</sup> Building on previous work, Kershaw shows that, even as relaxation did indeed occur, Marsh much overstates its salience. More important, Kershaw rejects the notion of an inappropriate accommodation of an unaccountable management class, instead explaining the relaxation as sensible adjustment in the

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<sup>1</sup> The word “erosion” is chosen in recognition of the following sentence in *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928): “Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions. . . .”

<sup>2</sup> Harold Marsh, Jr., *Are Directors Trustees? Conflicts of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966). Marsh’s article is a rare exemplar of corporate law scholarship with a long shelf life. So far in this century, scholars have cited it 71 times. The figure comes from a Westlaw LRJ search conducted on August 2, 2019.

<sup>3</sup> DAVID KERSHAW, *THE FOUNDATIONS OF ANGLO-AMERICAN CORPORATE FIDUCIARY LAW* (2018).

ordinary course of the caselaw's evolution—the result of judicial modification of principles from trust and agency law in their reapplication to corporate fact patterns.

This Article takes the occasion of Kershaw's critique to put the evolutionary erosion account to further questioning, asking whether it continues to exert normative power in today's corporate governance context. The answer is that it does not, for it is no longer relevant as a policy proposition. This result obtains even though erosion of the standards that courts apply to management self-dealing has continued unabated since Marsh published in 1966 and even though there is no reason to think that management self-dealing benefits the shareholder interest. The result follows from the operation of the corporate governance system, which has assimilated and redeployed the erosion account's motivating insight that officer and director self-dealing transactions do not make cost-benefit sense from the shareholder point of view. Today, the governance system itself discourages self-dealing transactions, and the judiciary no longer stands at the defensive front line. The normative implications of evolutionary erosion change accordingly.

To make the case for these propositions, the Article takes a new look at the role played by management self-dealing transactions in public corporations. The governance system, bolstered by federal disclosure rules, makes self-dealing transparent to shareholders, who have no reason to like it and now stand ready and able to register their preferences regarding such matters in corporate boardrooms. At the same time, the requirement of a majority independent board (imposed by the stock exchanges) makes self-dealing transactions by board members highly inconvenient, because self-dealing undercuts independence. The practice reflects the regulation, as shown by reference to hand-collected datasets of self-dealing transactions at publicly-traded companies and of litigation in respect of self-dealing transactions in the Delaware Chancery Court. The classic self-dealing transaction, though still a focal point of academic discourse on corporate fiduciary law, does not matter all that much in real world companies with dispersed shareholders. It is no longer an unsolved problem stemming from separated ownership and control.

This Article has five parts. Part I begins with Marsh's thesis and goes on to trace its diffusion into the literature as the generally-accepted account. Marsh identified three phases of corporate law history: first, a late 19<sup>th</sup> century phase in which all self-dealing transactions were

voidable at the company's option; second, an early 20<sup>th</sup> century phase in which self-dealing transactions were valid (and not voidable at the company's option) if approved by a majority of disinterested directors and judicially sustained as fair; and third, a mid-20<sup>th</sup> century phase in which any self-dealing transaction, whatever its approval process, could be judicially sustained as fair. Marsh's historical story invited critical inspection of present boardroom practice. Subsequent literature accepted the invitation, describing corporate boardrooms as inappropriate venues for decision-making respecting self-dealing transactions and diagnosing a problem of structural bias in favor of insider interests. Norms of collegiality and limitations on available information disabled outside directors from applying the appropriate standard of arm's-length contract. Meanwhile, dispersed shareholders could not self-protect, because the shareholder ratification process provided an intrinsically ineffective backstop due to informational constraints and collective action barriers. Two points followed. First, the best legal approach to self-dealing transactions is outright prohibition, which just happened to be the erosion account's lost historical starting point. Second, absent outright prohibition, substantive or procedural barriers to judicial review of transactional fairness were a bad thing. Both points resonated deeply in the context of the corporate governance system that prevailed when Marsh published and for many years thereafter.

Part II extends Marsh's historical story, showing how corporate fiduciary law continued to erode after he wrote. Today's plaintiffs face higher hurdles, and not just those from civil procedure, because today, judicial fairness scrutiny can be averted by a correct boardroom process. At the same time, the zone of contractual opting-out has expanded. Part II's presentation focuses specially on the duty of loyalty in Delaware law, where the final concession of disinterested director validation of self-dealing transactions is thought to have occurred relatively recently.<sup>4</sup> In fact, it has been 35 years since Delaware's scales tipped decisively toward boardroom validation.<sup>5</sup>

Part III takes up Kershaw's retelling of Marsh's historical story. Kershaw brings a fresh perspective, making comparative reference to the law of the United Kingdom (U.K.), from which nineteenth century courts in the United States (U.S.) derived the flat rule prohibiting self-dealing

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<sup>4</sup> The case is *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150 (Del. Ch. 2005), *aff'd* 906 A.2d 114 (Del. 2006).

<sup>5</sup> The case is *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

transactions. Kershaw shows that fundamental doctrinal differences made the U.K.'s prohibition dysfunctional in U.S. contexts. He also depicts the U.S. experience of doctrinal relaxation as a part of a neutral process of adjustment—the courts were gradually figuring out how to extend the basic outlines of trust and agency law to corporations. Relaxation therefore need not be explained as an expedient accommodation of a favored management interest. Significantly, Kershaw does not erase erosion from corporate fiduciary law's historical outline. But his account does negate the notion that categorical prohibition of self-dealing is the law's natural base point. This conclusion is seconded by reference to Adolf Berle's writing on the duty of loyalty, which looks at the same caselaw to draw very different conclusions from those of Marsh.<sup>6</sup>

Part IV turns to corporate governance today to reconsider the erosion account's normative conclusion--that corporate fiduciary law has evolved in a fundamentally unsatisfactory direction. Today's question is whether, in the present governance environment, in which shareholder preferences matter greatly (whether as regards the business plan or adherence to best practices), there remains sufficient slack to allow management to increase its returns systematically by entering into self-dealing transactions with the firm. The answer is no, at least so far as concerns companies where ownership and control are separated. Management, held to a lockstep salary system in Marsh's day, now gets its returns upfront in the form of liberal equity compensation. And, although it has been questioned whether these returns are excessive and whether management brings power to bear in garnering excessive gains, there also is evidence that arm's-length

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<sup>6</sup> Andrew F. Tuch, *Reassessing Self-Dealing: Between No Conflict and Fairness*, 88 *FORDHAM L. REV.* 939 (2019), covers much of the same territory as does this Article, including the reconsideration of Marsh and reception of Kershaw's points, but to very different effect. Professor Tuch's primary points are comparative, and his perspective is doctrinal as well as historical. He shows that U.S. fiduciary law and U.K. fiduciary have evolved so as to operate similarly even as they have very different doctrinal start points. As to this point, there is no quarrel here. This Article limits its observations to the U.S. system, and its primary points are normative and theoretical—its seeks to integrate an account of academic thinking about corporate fiduciary law with both an account of the evolution of the corporate governance system and an account of the evolution of the law itself. Most of this is orthogonal to Professor Tuch's account. This Article shares with Professor Tuch's confidence in shareholder decision-making, even as this Article's account of the evolution of Delaware law across the last five decades contrasts sharply with Tuch's.

Mention should be made of a third paper traversing this subject matter, Amir N. Licht, *Farewell to Fairness: Towards Retiring Delaware's Entire Fairness Review* (European Corporate Governance Institute - Law Working Paper No. 439/2019), <https://ssrn.com/abstract=3331097>, which predicts that the Delaware Court's increasing emphasis on shareholder ratification portends the disappearance of entire fairness review, bringing U.S. fiduciary law into line with that of other common law jurisdictions. Licht's doctrinal approach parallels Professor Tuch's but contrasts sharply with the normative view expressed here, which sees entire fairness scrutiny playing a positive role in corporate governance even as it takes its partial retreat with equanimity.

bargaining determines these outcomes. More important, returns to management (whether or not excessive), are universally seen to be generous, leaving managers no elbow room to make a real-world case for supplemental returns through side deals. Generalizing, a norm against classic self-dealing transactions has taken hold in the boardroom. Systemic requirements assure that the norm is enforced. Mandatory disclosure reduces the space for backroom coverups. Mandates and norms imposing majority and super-majority independent boards create an additional and potent stick—any outside director who procures an extra dollop of corporate gravy on the side loses his or her independence with a concomitant loss of governance utility. Finally, systemic improvements now render boardroom structural bias less of a problem.

These observations are backed up by reference to two hand-collected data sets. The first takes the 31 companies in the Dow Jones average and adds 31 companies from the S&P midcap 400 and 31 companies from the S&P smallcap 600 and reviews the policies and transactions reported in their most recent proxy statements. Although plenty of self-dealing transactions are reported—the searching nature of the disclosure rules assures that result—almost none figure materially in the context of the corporations’ financial reports. A small number of big-ticket transactions shows up at controlled companies, but there are business-based explanations even here with those. The second dataset reviews every duty of loyalty case in Westlaw’s Delaware Chancery Court database to test the salience of litigation concerning self-dealing transactions. Only a handful of reported cases concerning self-dealing transactions in publicly traded companies have appeared since the mid-1980s. Today’s public company fiduciary litigation is mostly about mergers and acquisitions, a subject matter as to which Marsh’s sought-for regime of prohibition makes no sense whatsoever.

Significantly, the small number of red-flag transactions go up in a subset of companies subject to blockholder control, a group making up 10% of the public company dataset.<sup>7</sup> This suggests a line-drawing exercise, with controlled companies excluded from this Article’s suggestion that the governance system now effectively checks self-dealing transactions. This

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<sup>7</sup> The categorization derives from a qualitative review of each company. The operative standard combines blockholding with an implication of control. Ten companies in the sample fit the specification. In eight of the ten, the holder owns more than 20% and either is or has been a top executive. In the remaining two cases, the blocks are less than 20% but the holder is a CEO who has exercised control for an extended period. Passive institutions like BlackRock and Vanguard, which own blocks of 5% or more in almost all of the companies, are not included.



suggestion is confirmed by reference to an additional dataset of the registration statements of 50 companies that conducted initial public offerings in the fall of 2019. In this group, blockholder control is the dominant governance mode and self-dealing transactions have greater economic salience. Even here, however, there is evidence of the operation of systemic constraints.

Part V reconsiders the meaning of evolutionary erosion by reference to recent developments in Delaware fiduciary law. The Article here takes a look at the erosion account's flip side, pointing to areas for which the envelope of fiduciary scrutiny has expanded and contending that Delaware, even as it has opened a door to boardroom validation of self-dealing contracts, has not dredged a safe harbor. Fairness scrutiny is blocked only when independent directors are in charge, and both director independence and blockholder control are established or negated under capacious, fact-sensitive standards. Meanwhile, Delaware's twice-testing rubric, the initial appearance of which dates back to 1971,<sup>8</sup> now forcefully moves Delaware fiduciary law in the direction posited by Adolf Berle eighty years ago.<sup>9</sup>

## I. EVOLUTIONARY EROSION, STRUCTURAL BIAS, AND THE ELUSIVE ARM'S LENGTH BARGAIN

A researcher looking for favorable academic commentary on the law of corporate self-dealing transactions—that is, for articles concluding that all is well and that the law creates a robust protective shield against injurious insider advantage-taking—will come up close to empty-handed.<sup>10</sup> The tradition is otherwise. The literature holds that the duty of loyalty has had an unhealthy evolution, starting out but then abandoning robust prohibition. It depicts a downward slide that proceeded in four stages to leave us with two unsatisfactory alternatives respecting self-dealing transactions. Under the first, an insider's deal with the company can be validated

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<sup>8</sup> The case is *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971).

<sup>9</sup> See A. A. Berle, Jr., *Corporate Powers As Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

<sup>10</sup> Only one such doctrinal paper appeared in the course of research for this article, David S. Ruder, *Duty of Loyalty - A Law Professor's Status Report*, 40 BUS. LAW. 1383 (1985) (reviewing the field in anticipation of an ALI project by reference to cases selected for inclusion in casebooks). Approving comments tend to show up in work reflecting a contractarian theoretical perspective. See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 15 (1991); Daniel R. Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U.CHI. L. REV. 1105, 1116 (1988) (looking at the inflexibility of trust law and commenting that corporate law's weaker constraints make sense in view of "a developed set of monitoring mechanisms").

internally, whether by disinterested director approval or shareholder ratification, assuring a skew favoring the interests of the insider and disfavoring the investor interest. Under the second, the deal can be validated as fair by a judge. This, though superior to internal approval, turns out, upon careful inspection, to be a questionable palliative.

The Part lays out the components of this conventional wisdom, reviewing Marsh's historical account in Section A, its restatement and extension by Dean Robert Clark in Section B, and the account's implications in Section C.

### **A. Erosion in History—the Marsh Thesis**

Harold Marsh described a three-phase declension of corporate fiduciary law. In the first phase, which began in 1880, the universal rule was that director and officer self-dealing transactions were voidable at the option of the corporation.<sup>11</sup> Phase two had begun by 1910. It was a more relaxed regime, in which a self-dealing transaction was valid if approved by a disinterested board majority and found fair by a reviewing court.<sup>12</sup> A transaction approved by an *interested* board majority, however, remained subject to avoidance at the option of the corporation. The distinction between majority-interested and majority-disinterested approval reflected the redeployment of a principle of trust law in the corporate context. Trust law provides that a trustee cannot transact with herself as regards trust property but can transact with the trust beneficiary, subject to fairness scrutiny. The courts, adapting these principles to corporate law, reasoned that approval by a majority-interested board was the equivalent of a trustee transacting with herself; in contrast, if a majority-disinterested board approved the transaction, it was as if the trustee were contracting with the beneficiary.<sup>13</sup> Marsh rejected this approach on policy grounds. Although the approach technically held out a possibility of *per se* avoidance (given approval by interested directors), it was a possibility that in Marsh's view would never be realized in the real world because disinterested board approval had become easy to get. Any process protection bound up in the requirement of a disinterested board majority had become nugatory when the courts conceded that interested directors could be counted for quorum purposes when a board convened to approve a self-dealing transaction. Thus, the transaction could be validated by the affirmative

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<sup>11</sup> See Marsh *supra* note 2, at 36-39.

<sup>12</sup> *Id.* at 39-40.

<sup>13</sup> KERSHAW, *supra* note 3, at 346-49.

vote of a minority of disinterested directors.<sup>14</sup> In addition, said Marsh, *per se* invalidity was no longer a possibility as regarded interlocked deals—transactions between companies with directors in common.<sup>15</sup>

Phase three of the history described the world that Marsh saw as he wrote in the mid-1960s. *Per se* invalidity, he said, was completely off the table and any self-dealing transaction could be judicially sustained as fair, however infirm the internal corporate process of approval.<sup>16</sup> But he also admitted that this description was not quite accurate doctrinally, for *per se* invalidity absent disinterested majority approval remained the common law of many states. Marsh argued that *per se* invalidity was a dead letter even so, due to the proliferation of exculpatory charter provisions and statutory safe harbors.<sup>17</sup>

Why had the doctrine evolved in this way? Marsh offered no explanation, even as he made clear his disapproval. For him, the reasoning in the early cases, which made the transactions voidable at the company's option, remained persuasive. According to those cases, influences within the boardroom made disinterested director approval intrinsically suspicious,<sup>18</sup> and approving directors could not be trusted to do an arm's-length check on one of their colleagues.<sup>19</sup> It was, said the courts, just a matter of human nature.<sup>20</sup> For Marsh, nothing in later opinions improved on or refuted that wisdom.

Marsh recommended a return to phase one's regime of prohibition, but with a federal administrative twist. State corporate law should be preempted, and the Securities and Exchange Commission (SEC) inserted in place of the state courts. Self-dealing transactions by SEC

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<sup>14</sup> See Marsh, *supra* note 2, at 41-42. To see the problem, assume a seven-seat board with five interested directors and two disinterested directors. All attend the meeting, with the interested directors being necessary to establish a quorum. The interested five abstain from the vote on the transaction, which is approved by the two disinterested directors, who constitute a majority of those voting.

<sup>15</sup> *Id.* at 42.

<sup>16</sup> *Id.* at 43.

<sup>17</sup> *Id.* at 45-50. The Delaware Supreme Court approved such a provision in *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 117-119 (Del. 1952).

<sup>18</sup> Marsh, *supra* note 2, at 37, *citing* *Munson v. Syracuse, G. & C. Ry. Co.*, 103 N. Y. 58, at 74, 8 N. E. 355, at 358 (1886).

<sup>19</sup> See Marsh, *supra* note 2, at 37, *citing* *Cumberland Coal and Iron Co. v. Parish*, 42 Md. 598, at 606 (1875).

<sup>20</sup> *Id.* at 38, *citing* *Memphis & C. R. Co. v. Wood*, 88 Ala. 630, at 642-43, 7 So. 108, at 112 (1889).

registered companies would be prohibited, subject to the possibility of SEC exemption on a showing of fairness and consistency with investor protection.<sup>21</sup>

## **B. Clark's Extension**

Dean Robert Clark's foundational corporate law treatise expanded on Marsh. It reached the same normative bottom line, strengthening it with a powerful cost-benefit showing. Clark also filled in the explanatory gap, in effect completing Marsh's historical presentation.

Clark's cost-benefit analysis upped Marsh's normative ante. Unfair self-dealing contracts inflict two modes of injury, said Clark: (1) they entail collection of unwarranted monopoly rents by their insider beneficiaries; and (2) they introduce unproductive uncertainty into securities valuation, in turn implying an increase in corporations' cost of capital.<sup>22</sup> For Clark, as for Marsh, existing correctives, whether emanating from corporate governance institutions or from market discipline, insufficiently protected shareholders from the possibility of injury: the system left open a zone of discretion within which management could self-serve. Meanwhile, Clark saw no cognizable benefits emanating from the "fair" subset of self-dealing transactions.<sup>23</sup> Any savings of transactions costs yielded by an inside deal would be small and hard to measure. For most goods and services, third-party provision could satisfy corporate needs. Situations for which the insider had the benefit of some special savings of production costs would be rare. Thus, except in the rare case, the costs outweighed the benefits. This conclusion yielded a revised version of Marsh's law reform proposal: as with Marsh, state law should be preempted and determinations on self-dealing transactions should be remitted to the SEC; but a manager seeking an SEC variance would face a tougher standard—the self-dealing transaction would have to be "better than fair."<sup>24</sup>

Turning to Marsh's history, Clark posed four possible reasons for the pattern of relaxation. First, the courts might have abandoned the original *per se* rule pursuant to a more general common law shift from rules to standards. Second, the fact patterns had changed. Where courts in the era of prohibition had dealt with the egregious doings of the robber barons who controlled mid-19<sup>th</sup> century railroads, later courts decided close corporation cases in which consent processes had more

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<sup>21</sup> *Id.* at 74-75.

<sup>22</sup> ROBERT CHARLES CLARK, CORPORATE LAW § 4.2, at 157 (1986).

<sup>23</sup> *Id.* §5.4 at 180.

<sup>24</sup> *Id.* §§ 5.4.2-5.4.3, at 185-188.

credibility. Third, accumulating experience could have cast self-dealing transactions in a more favorable light, with courts coming to appreciate that in some cases they made all parties better off. Fourth and finally, courts and legislatures had been captured by management.<sup>25</sup>

Clark kept his cost-benefit analysis and his historical gloss in separate silos. But the exercise of comparing the contents of the two yields irresistible synergistic gains. Let us accordingly deploy the cost-benefit exercise, which retains its power, in an evaluation of the competing historical hypotheses.

The first and second historical explanations (rules to standards and different case fact patterns) are neutral and doctrinal. Under these explanations, judicial approaches to corporate self-dealing transactions changed for the same reason that judicial approaches to many other problems changed in the early 20<sup>th</sup> century: the courts were responding to the merits of the cases before them and, in any event, were minded to take a more flexible, fact-sensitive approach to their common law decision-making. A tension arises when we consider these neutral doctrinal explanations in light of Clark's cost/benefit conclusion: although relaxation of fiduciary standards may have followed from the judicial conduct of business as usual, this was a case where the ordinary course conduct of business had a negative cost result. But, because the negative result presumably was unintended, corrective law reform could proceed as a similar business-as-usual proposition, for the first two explanations implicate no cost-benefit arguments favoring the management interest.

Clark's third explanation—that the benefits might outweigh the costs—followed from a contradictory cost-benefit appraisal. Let us assume that Clark has much the better of the cost-benefit case. A question arises: How could early 20<sup>th</sup> century courts have perceived benefits when any sensible review of the matter reveals an overwhelming raft of deadweight costs? If the answer to the question is that, in fact, there *were* no new benefits for inclusion in the early 20<sup>th</sup> century balance, then this third, cost-benefit explanation for evolutionary erosion is lacking in policy content. It reemerges as a makeweight, expedient justification for doctrinal change, a mantra mooted without anyone having really believed it. It follows that the third “explanation” is not

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<sup>25</sup> *Id.* § 5.1, at 162-63 (1986). Clark, worried about problems of proof, expressed skepticism about all but the second explanation.

really an explanation at all, at least when taken at face value. Reconsidered in context, it collapses into Clark's fourth explanation, management capture.

The capture explanation provides an answer to the question as to how the courts could have perceived non-existent benefits. Simply, they were insensitive to the cost side of the tradeoff because they catered to management. This explanatory alternative negates and subsumes the third explanation. It also synchronizes nicely with the first explanation: the shift from rules to standards facilitated doctrinal change motivated by a commitment to the management interest.

Unsurprisingly, the management capture explanation has considerable purchase in the literature. It facilitates the integration of the negative view of charter competition with learning on fiduciary law. It teaches us that the same forces that caused the corporate law race to the bottom<sup>26</sup> deleteriously influenced the legal treatment of self-dealing transactions. Significantly, market controls do not drop out of this picture. They remain in place as constraints on the self-serving misconduct of managers with a question arising regarding the constraint's intensity. Clark, like most of his contemporaries, concluded that the controls operated inadequately, proving insufficient to prevent injury to investors.

We emerge with a description in which governance institutions and markets operate together to build in considerable slack, leaving management a zone of discretion within which to line its own pockets. State fiduciary law figures importantly in the picture of causation: the choice of chartering jurisdiction lies with management, therefore states competing for charters will have an incentive to provide rules that accord management an envelope within which to redistribute wealth from the firm (and hence the shareholders) to themselves.<sup>27</sup>

### **C. Implications: Structural Bias, Market Failure, Judicial Failure**

Let us now reconsider the justifications for a rule of prohibition, as set out in the 19<sup>th</sup> century cases, in light of Marsh's historical case, as expanded on by Clark. One emerges with the essential components of the policy position regarding self-dealing transactions that continues to prevail in academic thinking. Under this, neither internal corporate decision-making processes nor

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<sup>26</sup> See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 670, 701 (1974) (depicting Delaware as leading in the deterioration of corporate standards).

<sup>27</sup> See Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1442, 1462 (1992).

outside judicial review provide any guarantee against systematic shareholder injury due to self-dealing. Something stronger is needed.

The corporate law literature provides three sets of more particular observations concerning the processes pursuant to which management self-dealing transactions are reviewed and (potentially) approved. One set concerns boardroom approval, the second set concerns shareholder ratification, and the third set concerns judicial review for fairness. Each of the three modes of transactional approval turns out to be inadequate, because none of the three guarantees the shareholders the same result that could have been obtained through bargaining at arm's length.

### 1. *The Boardroom.*

Corporate boardrooms are viewed as inhospitable venues for decision-making in the best interests of the shareholders whenever managers propose self-dealing transactions. Even a board with a disinterested director majority cannot be trusted, for all directors are “insiders” in a cognizable sense and, accordingly, are structurally biased in favor of accommodating other insiders. This picture of “structural bias” follows in part from the features of the corporate governance system at the time that Marsh and Clark wrote<sup>28</sup>—it had not yet taken a turn toward thoroughgoing control by independent directors.<sup>29</sup> In those days, CEOs retained control of the board nomination process, making even independent outsiders beholden to them for the favor of appointment and retention. Many directors, although disinterested in a particular transaction, had other significant business relationships with the company. Structural bias also has intrinsic causes that can be expected to persist—behavioral influences operating even given an independent board vested with control over nominations. These are the factors that give rise to sympathy for the self-dealer, such as common backgrounds and experiences, social ties, norms of collegiality, and in-

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<sup>28</sup> The leading contemporary account is MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* 205-06 (1971) (asserting that few boards put difficult questions, meaningfully evaluated the top team, or considered dismissal of an unsuccessful CEO).

<sup>29</sup> Observers began to acknowledge the change around the turn of this century. *See, e.g.*, Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 881-82 (2002); *The Professor: Jay Lorsch*, *DIRECTORS & BOARDS*, Fall 2001, at 18.

group dynamics.<sup>30</sup> Meanwhile, craven CEOs and other powerful insiders are ever ready to exploit the system's weakness and take whatever they can.<sup>31</sup>

Let us moot a managerialist comeback against this diagnosis. The comeback highlights the personal integrity of the sorts of people nominated to sit on corporate boards (even assuming CEO domination of the nomination process) along with the reputational constraints under which such people operate. This, says the proponent, assures "integrity." The assurance in place, the proponent turns to "discretion" and "flexibility." The corporate governance system works well as an economic machine precisely because the board is accorded a wide zone of discretion to manage the business. Just as the business plan is left to the board, so should we leave to the board the cost-benefit judgment on self-dealing transactions, at least so long as the deciding directors are disinterested.

The literature makes a powerful response to this comeback. The case for management invokes the business judgment rule and its justification, suggesting that all decisions should enjoy the rule's protection, despite structural bias. The problem with the argument is that it ignores corporate law, which only accords *unconflicted* decisions the degree of respect sufficient to close off ex post judicial review.<sup>32</sup> Furthermore, the business judgment constraint against ex post review of board decisions itself follows from a cost-benefit judgment—that shareholder returns are enhanced when courts respect a zone of decision-making discretion. When the decision concerns a self-dealing transaction, however, the law applies a radically different treatment to the fact

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<sup>30</sup> See, e.g., James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83, 91-108. The appearance of special committee power to effect dismissal of shareholder derivative actions in the late 1970s and early 1980s triggered a spate of this commentary. See, e.g., George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 111-13 (1980); John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 283 (1981); James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 962; Marc I. Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits*, 35 U. MIAMI L. REV. 1, 24 (1980); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 938 (1982). Courts also expressed concern regarding structural bias. See, e.g., *Clark v. Lomas & Nettleton Fin. Corp.*, 625 F.2d 49, 52-53 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981); *Watts v. Des Moines Register & Tribune*, 525 F. Supp. 1311, 1328 (D. Iowa 1981); *Joy v. North*, 519 F. Supp. 1312, 1321 n.5 (D. Conn. 1981), *rev'd*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

<sup>31</sup> Victor Brudney *Revisiting the Import of Shareholder Consent for Corporate Fiduciary Loyalty Obligations*, 25 J. CORP. L. 209, 210, 216 (2000).

<sup>32</sup> Absent a showing of gross negligence or bad faith. See, e.g., *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 52-53 (Del. 2006).



pattern—judicial review, or, indeed, prohibition—precisely because the cost-benefit outcome has flipped.<sup>33</sup>

## 2. *Shareholders' Meetings.*

Even if boards of directors cannot be trusted to decide about self-dealing transactions, there remains the alternative of shareholder ratification. But, under the prevailing wisdom, the shareholders' meeting makes for an even more ineffective venue than does the boardroom. This wisdom first circulated in the days in which shareholders were seen as “rationally apathetic” regarding proposals presented in proxy statements.<sup>34</sup> Given dispersed holdings and management control of the proxy machinery, it was thought that there was no incentive to invest in information gathering or politicking regarding even questionable proposals.<sup>35</sup> Furthermore, under the then-prevailing “Wall Street Rule,” the default voting choice was management support; if an investor took the view that the company was badly run, the best course was to sell.<sup>36</sup>

These conditions have changed: today, most shareholders are institutions that make reasoned voting decisions (or pay consultants to make reasoned decisions for them).<sup>37</sup> But there remains a strong argument that the shareholder venue is inappropriate in the context of self-dealing transactions. Shareholder ratification occurs after the fact. It cannot be deployed to replicate the context of an arm's length bargain: no amount of conventional disclosure puts voting shareholders in a position to make an effective business judgment regarding a given transaction, particularly a complex one.<sup>38</sup> The shareholders are, accordingly, dependent on the board to assess the costs and benefits of a given self-dealing transaction—a board already deemed incapable of proceeding at arm's length.

## 3. *Judicial Review for Fairness.*

A normative standard emerges in the above account: a valid self-dealing transaction should replicate the result that would have been obtained in an arm's length bargain. Given this standard, even judicial fairness scrutiny emerges as ill-suited to protect shareholders. To see this point,

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<sup>33</sup> See Brudney, *supra* note 311, at 231.

<sup>34</sup> See CLARK, *supra* note 252, §9.5.1, at 390-92.

<sup>35</sup> *Id.* §9.5.2, at 392-93 (discussing freeriding).

<sup>36</sup> See, e.g., George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 903-06.

<sup>37</sup> See *infra* notes 180-181 and accompanying text.

<sup>38</sup> See Brudney, *supra* note 311, at 218-19.

assume that a self-dealing transaction has been entered into based on the approval of an interested board and that a derivative plaintiff puts the deal in front of a court for fairness review—this is the situation posited in the third phase of evolution described by Marsh. The transaction, voidable *per se* under the law of the first and second phases now can be validated by the reviewing court. Assume that the court appraises the deal based on the price, making reference to comparable transactions. Also assume that the goods or services subject to the contract are not homogenous (and thus not available in a substitute transaction at a price set in the market) but differentiated. The price is accordingly a function of bargaining between a particular buyer and a particular seller. A reviewing court can refer to comparable trades for parameters within which such a price negotiation might occur, but within those parameters cannot ascertain the price that should have followed for the corporation in an arm’s length transaction. It instead sees a range of possible prices, all of which can be described as fair.<sup>39</sup> In this posture, fairness review does not and cannot guarantee that the shareholders get the functional equivalent of a transaction at arm’s length.

Suppose, however, that we add the “fair process” leg of the two-part fairness test applied by today’s Delaware courts.<sup>40</sup> In the hypothesized case, fair process implies full disclosure of the existence of the conflict and material transactional facts<sup>41</sup> by the insider counterparty, along with an unbiased corporate decisionmaker attempting in good faith to ascertain the best interest of the shareholders. This addition of process review leaves the shareholders at less of a structural disadvantage. But it does not assure them of an arm’s-length result. Even given full disclosure, the structural bias account negates the very existence of the sought-for neutral corporate decisionmaker.

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<sup>39</sup> See Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 998-99 (1988).

<sup>40</sup> See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

<sup>41</sup> See Eisenberg, *supra* note 39, at 1000-1001.

## D. Conclusion

Marsh and Clark came to a common conclusion favoring *per se* prohibition of self-dealing transactions,<sup>42</sup> an approach rarely seen in corporate law policy discussions today.<sup>43</sup> Even so, their *per se* approach made eminent sense, given their assumptions and descriptive findings. Self-dealing transactions were unlikely to benefit the shareholders and were rarely necessary for the effectuation of the business plan. Internal processes were likely to fail to assure that they had replicated an arm's-length result. Backstop judicial review could ameliorate the process problem but could not solve it. Prohibition (with a loophole for a showing of the rare transaction that was essential to the effectuation of the business plan) was the only available legal result that adequately addressed the problem. Marsh's historical account bolstered this conclusion: prohibition's once-upon-a-time prevalence much enhanced its plausibility in a modern policy case.

## II. EVOLUTIONARY EROSION—PHASE FOUR

Dean Clark, publishing in 1986, suggested that a fourth phase in the history of erosion of fiduciary constraints already might have begun. He referred to California Corporations Code section 310<sup>44</sup>—California's statutory safe harbor provision for self-dealing transactions. The section, he said, "could be read to exclude the need for a self-dealing transaction to pass a judicial

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<sup>42</sup> The approach has since disappeared but was evident in forward thinking regarding corporate law duties during the 1970s and 1980s. See Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) (suggesting that all going-private transactions be prohibited); Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) (suggesting that gains resulting from mergers of subsidiaries into parent corporations be divided equally between the parent and the subsidiary by a percentage of premerger values); Marvin A. Chirelstein, *Towards a Federal Fiduciary Standards Act*, 30 CLEV. ST. L. REV. 203 (1981).

<sup>43</sup> Professor Evan Criddle comes closest. Criddle poses an opposition between a republican approach keyed to prohibition in the teeth of empowerment and a classical liberal approach that accommodates with an eye to compensating beneficiaries for injuries received. He approves of the former and disapproves of the latter. Evan Criddle, *Liberty in Loyalty: A Republican Theory of Fiduciary Law*, 95 TEX. L. REV. 993 (2017). In line with the literature, there is even a Delaware stab in the back, *id.* at 999:

Inspired by classical liberalism, the Delaware Supreme Court has replaced the no-conflict and nonprofit rules in corporate law with an "entire fairness" test that allows corporate directors to conclude self-interested transactions without the consent of either the corporation's disinterested directors or its shareholders. The past two decades have also seen a growing number of states discard the no-conflict and no-profit rules in agency law and parts of trust law. These departures from fiduciary law's traditional requirements have been premised on the idea that courts should intervene in fiduciary relationships only as strictly necessary to rescue beneficiaries from material harm.

<sup>44</sup> CAL. CORP. CODE § 310 (Dec. 17, 2020, 9:25 A.M.), [https://leginfo.legislature.ca.gov/faces/codes\\_displayText.xhtml?lawCode=CORP&division=1.&title=1.&part=&chapter=3.&article=](https://leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?lawCode=CORP&division=1.&title=1.&part=&chapter=3.&article=)

test for fairness.”<sup>45</sup> Given this reading, it would follow that approval by a disinterested director majority could import business judgment as the standard of review. The statute, thus interpreted, imposed management’s view of the matter<sup>46</sup> and arguably took evolutionary erosion a further step downward.

Argument over the meaning of statutes like California section 310 would continue for another two decades. Even today there remains much confusion as regards the interrelation of the bundle of factors that come to bear on the legal status of self-dealing transactions—common law voidability, fairness review, business judgment protection, and the interplay of common and statutory law. Indeed, this is as confusing a subject matter as exists in corporate law. But today there is no doubt as regards the bottom line: in Delaware and in many other states, approval by a disinterested (or, alternatively, independent<sup>47</sup>) board majority imports business judgment as the standard of review; judicial review for fairness, always available during the third phase according to Marsh, now can be cut off in the boardroom. This development amounts to an emphatic lawmaking rejection of the academic view of self-dealing transactions described in Part I. And it does indeed carry evolutionary erosion to the lower, fourth phase predicted by Clark.

This Part dissects the fourth phase, focusing on Delaware law. Section A recounts Delaware’s path from fairness review to business judgment treatment. It turns out that, with the benefit of hindsight, we can fix the key moment in this evolution with the decision of *Aronson v. Lewis*<sup>48</sup> in 1984, two years before the publication of the Clark treatise. Confusion continued, because *Aronson* was a common law development and questions long persisted regarding the common law’s interaction with section 144 of the Delaware General Corporation Law, the statutory safe harbor provision for self-dealing transactions.<sup>49</sup> The discussion that follows highlights a strategy for reading the two sources of law together consistently. Section B looks to other aspects of corporate fiduciary law—the process rules governing shareholder derivative actions and the intermediate scrutiny brought to bear on mergers and acquisitions—to show that evolutionary erosion is indeed well advanced in the fourth phase.

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<sup>45</sup> See CLARK, *supra* note 252, § 5.1 at 160.

<sup>46</sup> See *supra* text accompanying note 311.

<sup>47</sup> “Disinterested” should be distinguished from “independent.”

<sup>48</sup> 473 A.2d 805 (Del. 1984).

<sup>49</sup> DEL. CODE ANN. tit. 8, sec. § 144.

## A. The Downward Path to Business Judgment Review

We begin with Delaware’s safe harbor statute and the question of interpretation it poses. Section 144 starts out by describing director self-dealing transactions and transactions between interlocked boards. It then holds out the possibility of validation: no such transaction “shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director’s or officer’s votes are counted for such purpose” if one of three conditions is fulfilled. The conditions are: under section 144(a)(1), good faith approval by the “affirmative votes of a majority of the disinterested directors,” even though the disinterested directors be “less than a quorum,” upon disclosure of all material facts concerning the director’s interest and the transaction; or, under 144(a)(2), good faith approval by a vote of the stockholders entitled to vote thereon upon disclosure of all material facts concerning the director’s interest and the transaction; or, under 144(a)(3), the transaction is fair as to the corporation as of the time it is authorized, approved, or ratified.

### 1. *Narrow and Broad Readings.*

There are narrow and broad readings of section 144. We begin with the narrow reading, under which the sole purpose of the section, which was first enacted in 1967, is to close off the common law route to *per se* voidability. To see how section 144 does this, return to the voidability regime described in Marsh’s phase two, under which a fair transaction that has not been ratified by the shareholders can be subject to voidability at the option of the company if the transaction has been approved by an interested director majority. Section 144 holds out alternative paths around this result. First, section (1) makes it possible to validate the transaction in the boardroom, even though a majority of the directors is interested. One simply has the interested directors abstain from voting. The barrier to voidability rises so long as a majority of the voting (and disinterested) directors approves. Note that, reading the section literally, this result obtains even if there is only a single disinterested director.<sup>50</sup> Second, section (3) leaves open a door to judicial validation for fairness however in firm the approval process within the corporation.

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<sup>50</sup> Some states make this explicit. See N.J.STAT.ANN. 14A:6-8(1)(b). The Model Business Corporation Act requires a minimum of two disinterested directors. See AMERICAN BAR ASSOCIATION, COMMITTEE ON CORPORATE LAW, DEFINITIVE MODEL BUSINESS CORPORATION ACT § 8.62(a) (March 2020) [hereinafter cited as MBCA].

Under the narrow reading, the statute only comes to bear only when a corporation (or a representative plaintiff suing on the corporation's behalf) seeks to (or asks a court to) void the contract; that is, it operates only in the territory of *per se* voidability described in Marsh's phases one and two. The statute does not come to bear in either a lawsuit for damages due to a breach of the duty of loyalty by a director or officer who is party to a self-dealing contract or in a lawsuit to set aside such a contract on the ground of breach of fiduciary duty. Note that the narrow reading is quite compatible with the section's language: the statute addresses itself to voidness or voidability "solely for th[e] reason" of the director's interest or as the result of the interested director's participation in the boardroom approval process, something that matters only in the context of *per se* voidability.

There are two problems with the narrow reading. The first stems from Marsh's characterization of phase three, under which *per se* avoidability has been removed from the table and courts always can review for fairness. To the extent that Marsh's characterization is accurate, the statute does no work and the legislature has made what amounts to an idle gesture. The second problem comes from the management interest, which wants the statute to be read to have significant defensive properties in present-day fiduciary lawsuits. Under the narrow reading, the statute plays only a marginal defensive role, for the manager who procures disinterested director approval still faces a common law action for breach of fiduciary duty and attendant fairness scrutiny.

We now turn to the broad reading. Under this reading, the statute applies to suits for breach of fiduciary duty in addition to suits to void the agreement. The reading confronts a facial linguistic barrier, for the proponent has to disregard its "solely for this reason" language. But the broad reading otherwise is literal. It elevates 144(a)(1) to an outcome-determinative role in fiduciary litigation. The means to this end is a disjunctive reading of the (a)(1), (a)(2), and (a)(3) alternatives. Under the reading, any of the three—disinterested boardroom approval, shareholder ratification, or a judicial fairness ruling—validates the transaction in the context of fiduciary review. The fact that the three sections are connected by “; or” (semi-colon, then or) stoutly supports the reading. When the smoke clears, disinterested director approval in the boardroom based on full disclosure validates the transaction *and* cuts off a duty of loyalty lawsuit. It follows

logically that the standard of review in such a case is business judgment, even though the section makes no reference to the business judgment rule.

## 2. Results from Outside of Delaware.

Which reading is correct? The question has come up in numerous states with 144-type sections in their corporate codes. The answers vary from state to state and from statute to statute, for the statutes' linguistic formulations differ, along with judicial attitudes.

Hypothesize a lawsuit for breach of fiduciary duty respecting a self-dealing transaction approved by a majority of disinterested directors after full disclosure. It is a case of first impression under a statute identical to section 144. The plaintiff argues that the transaction is unfair and asks the court so to rule. Defendant invokes the broad reading and argues that the transaction is berthed in a statutory safe harbor. Assume that the judge views boardroom validation processes to be intrinsically infirm due to structural bias and suspects that lawyers who customarily represent managers both drafted the statute and shepherded it through the legislature.

Such judges have gotten to fairness review two ways. The first route is to apply the narrow reading.<sup>51</sup> This is very easy to do linguistically but harder to do as a policy matter, for, as we have seen, to apply the narrow reading is to imply that the legislature was wasting its time when enacting the section. That objection could be answered by going back to Marsh and rereading him carefully. As we have seen, he did not deny that *per se* invalidity remained on the common law books. He just referred to statutes and charter provisions in the section 144 mold to argue that *per se* invalidity no longer presented a real problem.<sup>52</sup> Thus reread, Marsh supports a narrow reading of the statute: it is there to alleviate residual practitioner concerns about old cases.

The second route is more difficult, linguistically. The judge applies the broad reading and holds that the section covers actions for breach of fiduciary duty in addition to actions to void. But the judge nonetheless refuses to read the three subsections disjunctively, holding that fairness review remains available because “; or” means “; and” in this case.<sup>53</sup> The further explanation is that blocking fairness review in an action for breach of fiduciary duty is an historically momentous

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<sup>51</sup> See, e.g., *Remillard Brick Co. v. Dandini Co.*, 109 Cal. App. 2d, 405, 241 P.2d 66 (1952)(applying the narrow reading but also holding that fairness review is always available under the narrow reading).

<sup>52</sup> See *supra* note 17 and accompanying text.

<sup>53</sup> See, e.g., *Scott v. Multi-Amp Corp.*, 386 F.Supp. 44, 66-69 (D.N.J. 1974); *Cookies Food Products v. Lakes Warehouse*, 430 N.W. 2d 447 (Iowa 1988).

step to take. One therefore requires more in the way of a linguistic instruction from the legislature than the section's two "semi-colon or" connectors,<sup>54</sup> particularly given the possibility of a narrow reading. Note that, under section 144, these linguistic acrobatics could be avoided just by adopting the narrow reading. At the same time, in a state in which the statute omits the "solely for this reason" language, this strategy could be the only plausible alternative that preserves judicial review of self-dealing transactions.

Legislatures have been known to amend their safe harbor statutes in the wake of judicial readings in both modes. They sometimes have ratified the court<sup>55</sup> and other times have overruled it.<sup>56</sup> But the drift favors the broad reading and business judgment review in fiduciary contexts. The drafting history of the Model Business Corporation Act (MBCA) provides a focal point example. The MBCA's safe harbor has evolved from a statute susceptible to the narrow reading<sup>57</sup> to a statute explicitly incorporating the broad reading and simultaneously making it clear that disinterested director approval triggers a business judgment standard of review.<sup>58</sup>

### 3. *Delaware's Straddle.*

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<sup>54</sup> See Brudney, *supra* note 31, at 214-215.

<sup>55</sup> See WEST'S ANN. CAL. CORP. CODE §310, Legislative Committee Comments (1975)("There is an additional requirement that the transaction be just and reasonable as to the corporation at the time it is approved, which is intended to codify a judicial decision indicating that the courts in any event will review the transaction for fairness [Remillard Brick Co. v. Remillard-Dandinni Co., 241 P.2d 66, 109 C.A.2d 405 (1952)]").

<sup>56</sup> See N.J.STAT.ANN. 14A:6-8, Commissioner's Comment 1988 Amendments (1988)("The one case dealing with this provision, Scott v. Multi-Amp Corp., 386 F.Supp. 44, 66-69 (D.N.J. 1974), construed the word "or" in the prior statutory provision in the conjunctive, rather than the disjunctive, thus requiring the statutory criterion of "fairness" in every case. This revision to Section 14A:6-8 reflects what the Commission viewed to be a better reading of the section.")

For further discussion of the caselaw, see Ahmed Bulbulia & Arthur R. Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards*, 53 NOTRE DAME LAW. 201 (1977); Brudney, *supra* note 31, at 214-215, 228-229.

<sup>57</sup> For the first version, see MBCA § 41 cmt. (1969)(stating that the statute's function is "not to provide a basis for validating for all purposes a contract or transaction . . . but simply to establish that such a contract or transaction is not automatically voidable solely by reason of the director's interest," and that "in all other respects equitable principles continue to be applicable."). For the second version, see MBCA § 8.31 cmt. (1985)(stating that the "sole purpose of § 8.31 is to sharply limit the common law principle of automatic voidability" and that obtaining consent "does not... [make] the transaction automatically valid").

<sup>58</sup> See MBCA §§ 8.61(b), 8.62 (barring equitable relief, damage awards, or other sanctions in a proceeding by a shareholder in respect of a self-dealing transaction given full disclosure and approval by a disinterested majority of at least two directors).

The American Law Institute's model statute stands in contrast. It also presupposes the broad reading. But it stops short of shrouding disinterested director approval in the business judgment rule. To avoid the business judgment result it interpolates an intermediate scrutiny: the approving director must have been able "reasonably [to] have concluded that the transaction was fair to the corporation." See AMER. L. INST., PRINCIPLES OF CORP. GOV. § 5.02(a)(2)(B)(1994).



The Delaware caselaw adopts *both* the narrow and broad readings. This sounds incongruous and certainly is confusing. But we can at least attempt to make the resulting straddle intelligible by reference to the context.

(a) *Legislative intent.* We begin with the intent of the legislature that first adopted section 144. Here, commentators attribute to the legislature the intent of the drafter of the 1967 revisions to Delaware’s code, Professor Ernest Folk. Folk commented on section 144 in his own writing. Commentary on those comments in turn holds out competing statements of Folk’s intent. The leading article on interested director safe harbor statutes opines with certainty that Folk intended the section to “validate” the transactions for all purposes, and not just to block a *per se* taint.<sup>59</sup> Distinguished members of the Delaware bar opine with equal certainty that, when Folk said “validate,” he referred only to the possibility of blocking *per se* invalidation and not actions for breach of the duty of loyalty.<sup>60</sup>

(b) *Common law treatment of the duty of loyalty compared.* Reference to the intent of the legislature having turned out to be unhelpful, let us now flesh out the legal background, making reference to the Delaware courts’ articulation of a common law of judicial review of self-dealing transactions and other disloyal conduct, a caselaw that covers the same territory as section 144 but also extends beyond. The existence of a second and parallel common law track is confusing, but unavoidable. Section 144 covers only completed transactions between the corporation and its directors or officers and transactions between companies with interlocked boards.<sup>61</sup> The realm of actionable fiduciary misconduct is much broader, covering any action injurious to the corporation

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<sup>59</sup> See Bulbulia & Pinto, *supra* note 56, at 212 (noting that Folk distinguished section 144 from the narrow interpretation applied by the California court to its own statute in *Remillard Brick*).

<sup>60</sup> See R. Franklin Balotti, Donald A. Bussard & Thomas A. Uebler, *The (Mis)application of Section 144*, 26-SPG DEL. LAW. 22, 26 DEL. LAW. 1 (Spring 2008) (referring to Ernest L. Folk III, *The Delaware General Corporation Law: A Commentary and Analysis* 82 (1972): “A contract or transaction covered by the statute is not void or voidable solely because those approving a transaction have a conflict of interest. . . . The validating effect does not go beyond removing the spectre of voidability. . . .”). See also Blake Rohrbacher, John Mark Zeberkiewicz & Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 723-724 (2008) (citing ERNEST L. FOLK, III, *REVIEW OF THE DELAWARE GENERAL CORPORATION LAW* 67 (1967), and quoting the following: “The need for loosening the traditional common law restrictions on interested director transactions has been recognized in decisions validating by-laws varying the common law rules. These more flexible procedures clearly ‘fill a legitimate need in the efficient functioning of the corporate enterprise.’”).

<sup>61</sup> DEL. CODE ANN. tit. 8, sec. § 144(a). Note that section 144 does not apply in a case to enjoin a transaction which, if completed, would fall within the section. See *Cooke v. Oolie*, 1997 WL 367034, at \*9 (Del. Ch.).

whether or not involving a completed transaction.<sup>62</sup> It follows that section 144 cannot possibly preempt the common law entirely even as it might displace its zone of operation as regards self-dealing transactions.

A strong implication favoring the narrow reading promptly arises. The logic is that only the common law can provide a unitary and exclusive source of law when questions arise concerning breaches of the duty of loyalty. Further reference to section 144 in the subset of fiduciary cases concerning completed self-dealing transactions only imports confusion. Furthermore, *pace* Marsh, the enacting legislature was not wasting its time, for there were reasonably recent cases of *per se* invalidation on Delaware's books at the time of section 144's enactment,<sup>63</sup> importing credibility to a narrow reading of the legislature's motivation.

What then does Delaware's common law have to say about the big question arising under section 144—the one concerning business judgment review in fiduciary litigation respecting transactions approved by a majority independent board? Here the touchstone is the Delaware Supreme Court's 1984 opinion in *Aronson v. Lewis*, which reformulated the judicial standard governing the dismissal of a complaint in a shareholder derivative action for failure to make a demand on the board of directors. If demand is deemed "futile," it is excused and the complaint survives a motion to dismiss. Under *Aronson*, demand can be deemed futile based on specific allegations in the complaint, as follows:

“. . . [T]he Court of Chancery . . . must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof. . . . As to the former inquiry, directorial independence and disinterestedness, the court reviews the

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<sup>62</sup> In Delaware, a director may be held liable for breach of the duty of loyalty in the absence of a personal benefit. *See* *Strasburger v. Earley*, 752 A.2d 557, 581 (Del. Ch. 2000).

<sup>63</sup> *See* *Blish v. Thompson Automatic Arms Corp.*, 64 A.2d 581, 602-03 (Del. 1948) ("Therefore, if during the course of a meeting a matter arises involving a Director's personal interest, a new count of those present should be had to determine whether or not a quorum exists without the interested Director."); *Kerbs v. Cal. E. Airways, Inc.*, 90 A.2d 652, 658 (Del. 1952) (finding that, because a profit-sharing plan was approved by only three disinterested directors on an eight-person board, "the plan failed to receive a legal majority of the directors' votes in its favor").

factual allegations to decide whether they raise a reasonable doubt, as a threshold matter, that the protections of the business judgment rule are available to the board. Certainly, if this is an “interested” director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases. In that event futility of demand has been established by any objective or subjective standard.”<sup>64</sup>

The test later would be restated in the disjunctive, with an “or” substituted for the “and” between (1) and (2) above.<sup>65</sup>

*Aronson*, in laying down a pleading specificity requirement for a derivative plaintiff, implies something about the operation of the business judgment rule on a self-dealing fact pattern. Simply, if a majority of “disinterested and independent” directors approved the transaction, then the business judgment rule applies to protect it.<sup>66</sup> The implication gradually took hold as common law. It accordingly has become the practice in Delaware fiduciary litigation for the court to examine each member of the approving board for disinterest and independence. Given majority independence at the conclusion of this court, the standard of review is business judgment, and the transaction is highly likely to pass inspection; given majority interest or dependence, the plaintiff gets by a motion to dismiss, business judgment protection does not obtain, and the court proceeds to review for fairness.<sup>67</sup>

Thus read, *Aronson* ushered in the business judgment review of self-dealing transactions as a common law proposition a long time ago. One can even track the common law line of authority farther back than *Aronson*. A 1971 Chancery Court decision states flatly that business judgment review follows from approval by a majority disinterested board.<sup>68</sup> The 1981 decision of *Zapata Corp. v. Maldonado*<sup>69</sup> strongly implies the same thing when it holds that a board of

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<sup>64</sup> *Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984)

<sup>65</sup> *See Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

<sup>66</sup> *See Paramount Communications v. QVC Network, Inc.*, 637 A.2d 32, at 42 n.9 (Del. 1993); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1154 (Del. Ch. 1994).

<sup>67</sup> *See, e.g., Gantler v. Stephens*, 965 A.2d 695, 713 (Del. 2009); *In re INFOUSA*, 953 A.2d 963 (Del.Ch. 2007)(conducting an individual count of the members of a board in connection with demand futility); *Beneville v. York*, 769 A.2d 80 (Del.Ch. 2000)(holding that one member of a two member board did not suffice to establish an independent board majority for demand excusal purposes).

<sup>68</sup> *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971)(holding that approval by an independent majority yields business judgment scrutiny in a case where a 46 percent shareholder controlled four out of nine seats).

<sup>69</sup> 430 A.2d 779 (Del. 1981).

directors has the power to terminate a derivative suit<sup>70</sup> subject to modified business judgment review given delegation of the matter to a special committee of independent directors. The limiting modification, inserted due to worries about structural bias in the boardroom,<sup>71</sup> was left to the discretion of the Chancery Court, which was authorized to substitute its own business judgment for that of the board in the proper case.<sup>72</sup> The modification by no means cuts off the implication that self-dealing transactions can lie in business judgment territory. If independent directors can terminate an otherwise well-pleaded derivative action subject to business judgment review (in the Chancellor's discretion), then the business judgment envelope also contains their approval of the underlying transaction and an attacking shareholder cannot invoke fairness scrutiny as of right.

Let us now return to section 144 to reconsider the broad reading in light of the common law. Awkward questions about the application of section 144 in the area of overlap crop up immediately because the two sources of law do not align perfectly, even as they roughly parallel one another. Section 144(a)(1) speaks only of “disinterested” directors, where post-*Aronson* common law more strictly demands “disinterest and independence.” Disinterest goes to the connection between the particular director and the transaction—a director is “interested” when he or she stands to gain monetarily while other shareholders do not.”<sup>73</sup> In Delaware common law, “independence” is a contextual inquiry directed to the director's connection to the company, its CEO, and its large shareholders. The question is whether a director, although lacking a direct financial interest in the matter, is somehow “ beholden ” to an interested colleague or otherwise likely to decide based on “personal or extraneous considerations,” rather than in the best interest of the corporation.<sup>74</sup> It follows that, given the broad reading, section 144(a)(1) could yield business judgment review for a transaction where the common law would not, for the approving directors could be “disinterested” in the transaction but still beholden more broadly.

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<sup>70</sup> *Id.* at 785.

<sup>71</sup> *Id.* at 787 (“[W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a ‘there but for the grace of God go I’ empathy might not play a role.”)

<sup>72</sup> *Id.* at 788.

<sup>73</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating that “directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally”). Note that if a director is interested, the director is by definition self-dealing.

<sup>74</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993).

The common law and section 144 are misaligned on other ways as well. Majority approval tabulations work differently. Section 144 contemplates approval by a disinterested minority of a majority interested board, where the common law looks for a majority independent board. (It is noted that under the common law a majority interested board could still validate a transaction for fiduciary purposes by delegating the matter to an independent committee of itself.<sup>75</sup>) Finally, shareholder ratification may work differently. At common law, interested shareholder votes do not count, and a majority of disinterested shareholders is needed to shift the standard of review. Section 144(a)(2) asks for a “good faith vote of the stockholders”<sup>76</sup> but goes no further, possibly counting interested votes.<sup>77</sup>

A clear doctrinal message emerges from the comparison: the only way to make Delaware work consistently is to adopt the narrow reading of section 144. Delaware courts have shown keen awareness of this point, even as they assiduously have held back from making a caselaw holding. Three explanations are possible. First, a mixed interpretation enhances judicial elbow room. Second, for many years, a clear-cut adoption of the broad reading would have attracted unwelcome criticism from academics and other advocates of the shareholder interest. Third, and contrariwise, a clear-cut adoption of the narrow reading would discomfit the management interest. A close look at the cases confirms all three explanations.

*(c) Cases under section 144: 1976-1996.* The line of cases applying section 144 starts off with the narrow reading in a dictum in a 1976 Supreme Court case.<sup>78</sup> The Chancery Court, also in a dictum, again confirmed the narrow reading a decade later.<sup>79</sup> Then, in 1991 and in yet another dictum, the Supreme Court turned to the broad reading and a business judgment standard of review,

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<sup>75</sup> See 8 DEL. CODE ANN., tit 8, §141(c). See also *Lewis v. Fuqua*, 502 A.2d 962, 971 (Del. Ch. 1985) (holding that conclusions of a one-person special litigation committee would be acceptable if the committee is independent, acts in good faith, and shows a reasonable basis for its conclusions), appeal denied sub nom. *Fuqua Indus. v. Lewis*, 504 A.2d 571 (Del. 1986).

<sup>76</sup> 8 DEL. CODE ANN., tit. 8, §144(a)(2).

<sup>77</sup> See *In re Cox Communications Shareholders Litigation*, 879 A.2d 604, 615 (Del.Ch. 2005). *But cf.* *In re Wheelabrator Technologies Inc. Shareholder Litigation*, 663 A.2d 1194, 1203 (Del Ch. 1995)(opining that shareholder ratification within section 144(a)(2) requires a majority of disinterested shareholders).

<sup>78</sup> *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

<sup>79</sup> *Marciano v. Nakash*, 535 A.2d 400, 403-404 (Del. Ch. 1987). Meanwhile, Chancellor Allen opined as follows in *Merritt v. Colonial Foods, Inc.* 505 A.2d 757, 763-64 (Del. Ch. 1986): “Self-dealing transactions by corporate officers, directors or controlling shareholders are not prohibited by Delaware law. Indeed, our statute provides specific special procedures that may be employed to remove the taint that any such transaction may possess solely by reason of its self-interested character. See 8 Del.C. § 144.” As between the two readings, this comment does not take a clear position.

conditioning it on the use of a special committee of independent directors.<sup>80</sup> The Chancery Court took this line of interpretation a step farther in its next dicta four years later. This time, a majority of “independent and disinterested” directors could procure business judgment review under section 144. Note that, with these pronouncements, the common law insistence on independence (as opposed to disinterest taken alone) seeps into section 144, despite the section’s wording to the contrary. The Chancery Court moved similarly as regards shareholder ratification, specifying a majority of disinterested stockholders under 144(a)(2).<sup>81</sup> The courts, in short, were quietly undertaking the job of bringing the common law and section 144 into alignment.

Meanwhile, the first Chancery Court pronouncement that could not be dismissed as dictum<sup>82</sup> had been made a year earlier, in the famous 1994 remand of *Cinerama, Inc. v. Technicolor, Inc.*<sup>83</sup> The question, which the reversing Supreme Court had requested the Chancery Court to answer, was whether one or more of the directors approving a merger agreement had an “interest” in the transaction within the meaning of section 144. Chancellor Allen ruled as follows:

The Supreme Court has mandated that this court consider the applicability of Section 144 of the General Corporation Law to the facts as found. As the Court noted, the application of that provision was not argued before this court. That statute does not deal with the question when will a financial interest of one or more directors cast on the board the burdens and risks of the entire fairness form of judicial review. Rather it deals with the related problem of the conditions under which a corporate contract can be rendered “unavoidable” solely by reason of a director interest. . . . [A]s construed by our Supreme Court

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<sup>80</sup> *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991)(“At common law, a corporation's stockholders did have the power to nullify an interested transaction, although considerations of the transaction's fairness appear to have played some part in judicial decisions applying this rule. *See, e.g., Potter v. Sanitary Co. of Am., Del.Ch., 194 A. 87 (1937); see also Marciano v. Nakash, Del.Supr., 535 A.2d 400, 403 (1987).* The enactment of 8 Del.C. § 144 in 1967 limited the stockholders' power in two ways. First, section 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule. Second, where an independent committee is not available, the stockholders may either ratify the transaction or challenge its fairness in a judicial forum, but they lack the power automatically to nullify it. When a challenge to fairness is raised, the directors carry the burden of ‘establishing ... [the transaction's] entire fairness, sufficient to pass the test of careful scrutiny by the courts.’”)

<sup>81</sup> *Lewis v. Fuqua*, 502 A.2d 962, 970 (Del. Ch. 1995) (director approval); *In re Wheelabrator Technologies Inc. Shareholder Litigation*, 663 A.2d 1194, 1203 (Del Ch. 1995)(shareholder ratification). *Wheelabrator*, which cites *Marciano, see id.*, can be read as adopting the narrow interpretation. But the matter is not free from doubt because the opinion also mentions a burden shifting effect and a shift of the reviewing standard to waste.

<sup>82</sup> The pronouncement was not necessary to decide the case so cannot be called holding. But it cannot be brushed off as unnecessary because the Supreme Court required the Chancellor to make the pronouncement.

<sup>83</sup> 663 A.2d 1134 (Del. Ch. 1994).

recently compliance with the terms of Section 144 does not restore to the board the presumption of the business judgment rule; it simply shifts the burden to plaintiff to prove unfairness. See *Kahn v. Lynch Communication Systems*, Del.Supr., 638 A.2d 1110 (1994).<sup>84</sup>

In this ruling, Chancellor Allen combined the broad and narrow readings. His reading started out squarely narrow, when it noted that section 144 did not apply to the fact pattern at hand and concerned *per se* invalidity. But it went broader when ascribing a burden-shifting effect to the section. The reason that the interpolation of burden-shifting went with the broad reading is that the burden-shifting is something that happens only in the context of an action for breach of fiduciary duty, which lies entirely on the broad side of the line.<sup>85</sup> The interpretation was doubly interesting for its citation of *Kahn v. Lynch*<sup>86</sup> as the controlling case on the meaning of section 144. That was a majority-to-minority fiduciary duty case, not a director to corporation self-dealing case. It accordingly did not lie in section 144 territory. Indeed, the Supreme Court's *Kahn v. Lynch* opinion nowhere mentions section 144.

Nonetheless, the Supreme Court on appeal commented that, with the above-quoted language, “the Court of Chancery properly began its consideration of Section 144.”<sup>87</sup> It went on to concede that section 144 did not in fact apply to the facts of *Cinerama*, but could be viewed as a source of general principles in common law contexts. As such, section 144 just happened to dovetail with *Aronson*, providing authority for the proposition that disinterested and independent majority board approval secured business judgment review. Thus did the Supreme Court in the end take us back to the full-dress broad reading even as it approved as proper the Chancellor's narrow and halfway broad readings.<sup>88</sup> Meanwhile, the Chancery began to apply section 144 in partly narrow-partly broad (with burden shifting) mode described by Chancellor Allen.<sup>89</sup>

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<sup>84</sup> *Id.* at 1153-1154.

<sup>85</sup> There is a technical reason for this. Under the narrow reading, satisfaction of 144(a)(1) or 144(a)(2) ends the invalidity case in the transaction's favor. There is no call to consider fairness and no inquiry into burdens.

<sup>86</sup> 638 A.2d 1110 (Del. 1994).

<sup>87</sup> *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1169 (Del. 1995).

<sup>88</sup> It bears noting that in the opinion remanding *Technicolor* to Chancellor Allen, the Supreme Court discussed section 144 in terms most consonant with the narrow reading. See *Cede & Co. v. Technicolor, Inc.* 634 A.2d 345, 365–366 (Del. 1993). Then, in a footnote, it adopted the broad reading. *Id.* at 366 n. 34.

<sup>89</sup> See *In re Wheelabrator Technologies Inc. Shareholder Litigation*, 663 A.2d 1194, 1203 (Del Ch. 1995).

Let us pause to sum up. We have covered twenty years. At the start, the Delaware courts were asked to choose between two inconsistent readings of section 144: broad and narrow. At the end, the Delaware courts had added a third reading—mixed broad and narrow with burden-shifting. In one or another case the Delaware courts had given their imprimatur to all three readings. There may even have been four readings, with the fourth invoking the statute not as a directive but as a flexible, caselaw-like bundle of principles.

The straddle would continue.

*(d) Cases under section 144 from 1997.*

In 1997, the Chancery Court applied section 144 for the first time in deciding a case for breach of fiduciary duty (and posing no question concerning *per se* invalidity). The case was *Cooke v. Oolie*.<sup>90</sup> The Court made no mention of the possibility of a narrow reading and employed the broad reading but interpolated burden-shifting in place of business judgment as the consequence of successful invocation of section 144(a)(1).<sup>91</sup>

The other readings did not disappear in the case's wake, however. Two years later, in *HMG/Courtland Properties, Inc. v. Gray*,<sup>92</sup> (then) Vice Chancellor Strine continued the use of 144 as case-like precedent. *HMG* was a common law case in which an interested director had not disclosed his interest to the reviewing board but argued that under the common law (as opposed to section 144(a)(1)) such disclosure was unnecessary. The court turned to the section 144(a)(1) requirement of disclosure of director interest as a source of law, even though it did not apply the section to the facts of the case. Vice Chancellor Strine also invoked the broad reading in reaching this result.<sup>93</sup> Six years later, he would again comment on section 144 in his *Cox Communications* opinion.<sup>94</sup> But this time he would pay his respects to the body of practitioner literature stating the case for the narrow reading and go on to identify points of misalignment between the 144 and

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<sup>90</sup> *Cooke v. Oolie*, 1997 WL 367034 (Del.Ch.). The complaint alleged waste, misappropriation, and breach of the duty of care. *Id.* at \*2. Two years earlier, in *In re Wheelabrator Technologies Inc. Shareholder Litigation*, 663 A.2d 1194, 1203 (Del Ch. 1995), the Chancery Court had supplemented a common law opinion regarding the effect of shareholder ratification with a footnote to section 144 noting that the section “also” reached the same result. *Id.* at 1204 n. 8.

<sup>91</sup> The court, having sustained the process case for application of 144(a)(1), granted summary judgment to defendants because the plaintiff had failed to sustain the burden to show the transactions unfair. 1997 WL 367034, at \*9-\*11.

<sup>92</sup> 749 A.2d 94 (Del. Ch. 1999).

<sup>93</sup> *Id.* at 112-114.

<sup>94</sup> *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del.Ch. 2005).



common law treatments.<sup>95</sup> It is not clear whether he discussed the practitioner literature with approval, but the implication does arise.<sup>96</sup>

Section 144 was applied in deciding a case for a second time in 2005 in *Benihana of Tokyo, Inc. v. Benihana, Inc.*<sup>97</sup> Vice Chancellor Parsons applied three of the readings approved in Supreme Court opinions in a heroic attempt to synchronize 144 and the common law. The resulting structure does not quite work, analytically speaking. But, in view of the variegated character of the caselaw background, the attempt commands complete respect.

Vice-Chancellor Parsons begins with the narrow reading: 144(a) only averts *per se* invalidity. Fiduciary review and determination whether the standard of review is business judgment or fairness proceeds on a different common law track.<sup>98</sup> Within 144, if a defendant establishes the applicability of either of 144(a)(1) or 144(a)(2), the result is to forestall invalidation due to director interest and to shift the burden of proof to the plaintiff in order to prove the transaction unfair and thus invalidate it. Further, if 144(a)(1) compliance is shown, the interested director's interest in the transaction does not forestall application of the business judgment rule.<sup>99</sup> Finally, the Vice Chancellor noted that establishment of compliance with 144(a)(1) or 144(a)(2) does not yield business judgment review, for that is a matter for the separate fiduciary track.<sup>100</sup>

Cut through all of the above and one emerges with an approach grounded in the narrow reading, which is a good approach from the point of view of the coherence of Delaware corporate law. Two lingering problems remain, however. First, the court's interpolation of a burden shift on fairness within section 144 (read narrowly) based on satisfaction of (a)(1) or (a)(2) is questionable (albeit in accord with the precedent). Under the narrow reading, the only question is *per se* invalidation due to approval by a majority-interested board. A showing by the transaction's proponent of either disinterested director approval or shareholder ratification cures that problem; there is no occasion for further reference to fairness or unfairness with the context of section 144. Contrariwise, if the proponent fails to satisfy (a)(1) or (a)(2), it still has a chance

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<sup>95</sup> *Id.* at 614-615, *citing* David A. Drexler, Lewis S. Black & A. Gilchrist Sparks, III, DEL. CORP. L. & PRACTICE, § 15.05[2] at 15-22 (2004).

<sup>96</sup> *See also* Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 504 (2002).

<sup>97</sup> 891 A.2d 150 (Del. Ch. 2005).

<sup>98</sup> *Id.* at 173-174.

<sup>99</sup> *Id.* at 173.

<sup>100</sup> *Id.* at 185.

to avert *per se* invalidation by showing fairness. It follows that the three section 144(a) alternatives should be read literally and disjunctively; either disinterested director approval or shareholder ratification should end the matter of *per se* invalidity. Second, the court's reference to the business judgment rule in connection with satisfaction of 144(a)(1) is surplusage. The topic being *per se* invalidation, business judgment at no point comes into play; the contract is valid or invalid by virtue of the taint, whatever the quality of the boardroom decision process. But these are quibbles. *Benihana* left the Delaware law of self-dealing transactions in its most coherent shape for two generations. The result is that voidability due to the taint is alive and well in Delaware law. But, very much in line with Marsh, getting to voidness will as a practical matter will take a showing of unfairness and hardly seems worth the trouble.

The story continues. The *Benihana* plaintiff appealed a few issues. Affirming by reference to the facts, the Delaware Supreme Court in passing combined 144(a)(1) with a business judgment standard of review, which was not the approach taken by the Chancery Court.<sup>101</sup> The Court's accompanying doctrinal pronouncement could, but need not, be read as consistent with the broad reading.<sup>102</sup> In any event, the broad and narrow readings continue their uneasy parallel subsistence in subsequent cases.<sup>103</sup>

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<sup>101</sup> *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. Supr. 2006).

<sup>102</sup> *Id.* at 120 (“Section 144 of the Delaware General Corporation Law provides a safe harbor for interested transactions, like this one, if ‘[t]he material facts as to the director’s ... relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors ... and the board ... in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors....’ After approval by disinterested directors, courts review the interested transaction under the business judgment rule, which ‘is a presumption 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.’”)

<sup>103</sup> In *Valeant Pharmaceuticals International v. Jerney*, 921 A.2d 732 (Del. Ch. 2007), the Chancery Court applies the narrow reading and finds the transaction fails to satisfy any of the three conditions of the section. Voidness and damages follow, with a parallel action for breach of fiduciary duty acknowledged. *Id.* at 750-752.

In a dictum in *Reddy v. MBKS Co., Ltd.*, 945 A.2d 1080, 1087 n.15 (Del. 2008), the Supreme Court noted that it could void a self-dealing transaction due an approval taint unremedied under section 144.

Finally, in *Sutherland v. Sutherland*, 2009 WL 857468 (Del. Ch.), the Chancery Court rules that failure to satisfy 144(a)(1) or 144(a)(2) leaves the transaction “not insulated on grounds of unfairness.” *Id.* at \*4. The ruling is consistent with the narrow reading. The case involved a three-person board, with two of the persons interested in the transaction and the third, disinterested director voting to approve with the interested directors abstaining. The implication of the holding that 144(a)(1) is unsatisfied is that a single director cannot validate a transaction under the section. This in effect interpolates the RMBCA's minimum of two, see *supra* note 50, into section 144.

But it should be mentioned that *Sutherland*, in its recounting of history rejects the narrow reading and endorses the broad reading as follows, *id.* at \*4, n. 13:

Notably, before the law related to Section 144 of the DGCL finally settled, see, e.g., *Benihana of Tokyo, Inc. v. Benihana, Inc.*, [906 A.2d 114, 120 \(Del.2006\)](#) (providing that interested director transactions approved pursuant to the 144(a)(1) safe harbor are reviewed under the business judgment rule), it was

(e) *Conclusion.* One hopes that *Benihana*'s quasi-narrow reading will stick in the long run. But very little turns on the point, for the common law now does the lion's share of the work in Delaware duty of loyalty jurisprudence (and maybe even more than that), proceeding on the track set long ago in *Aronson*. That being case, perhaps matters best could be resolved by the Council of the Delaware Bar's Section of Corporation Law the next time it undertakes a broad-based project of revision of Delaware's corporate code. Here is the proposition: if section 144 no longer does any work that needs doing, then it should be repealed. Almost nothing would change in consequence but for a few residual questions arising in the rare case in which a plaintiff claims that the corporation has a right to *per se* invalidity. The Delaware courts are quite capable of drawing on the common law to provide answers as the occasion arises.

## **B. Additional Erosion**

The appropriateness of business judgment treatment for boardroom-approved management self-dealing contracts has been a flashpoint issue in corporate law for decades. When a jurisdiction endorses business judgment treatment it turns its back on *Marsh* and descends into the fourth phase of history predicted by Clark.<sup>104</sup> Underscoring this rejection of *Marsh*, the drafters of the MBCA completely removed the term "fiduciary" from their code and commentary in 1984,<sup>105</sup> apparently on the ground that it unjustifiably heightened expectations about the character of management duties.

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frequently suggested that Section 144, in the same vein as the provision at issue, did no more than to remove a director's disability to participate in a quorum to vote on an interested transaction, but did nothing to sanitize such a transaction if it was inherently unfair. *See, e.g., Fliegler v. Lawrence*, [361 A.2d 218, 222 \(Del.1976\)](#) ("[Section 144] merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved. Nothing in the statute sanctions unfairness ... or removes the transaction from judicial scrutiny."); *HMG/Courtland Props., Inc. v. Gray*, [749 A.2d 94, 114 n. 24 \(Del.Ch.1999\)](#) ("Satisfaction of §§ 144(a)(1) or (a)(2) simply protects against invalidation of the transaction 'solely' because it is an interested one."); *Cooke v. Oolie*, [1997 WL 367034, at \\*8 \(Del.Ch.\)](#) ("It is now clear that even if a board's action falls within the safe harbor of section 144, the board is not entitled to receive the protection of the business judgment rule.").

Elsewhere, however, the *Sutherland* court endorses reference to *Aronson* as the controlling precedent. *Id.* at \*4 n.14.

<sup>104</sup> For an excellent, extended treatment of this topic, *see* Julian Velasco, *The Diminishing Duty of Loyalty*, 75 WASH. & LEE L. REV. 1035 (2018).

<sup>105</sup> *See* Norwood P. Jr. Beveridge, *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 656 (1992), *citing* MBCA, § 8.30(a) cmt. at 222 (1984). Reference also can be made to MBCA, subchapter F, introductory cmt. (2012)(avoiding use of the term fiduciary except to describe historical antecedents).

These developments by no means stand alone in recent history. The list of additional modifications is long. Many concern process and are directed against representative litigants. *Aronson's* pleading specificity requirement<sup>106</sup> substantially raised the bar confronting derivative plaintiffs. *Zapata's* concession of boardroom power to terminate derivative actions<sup>107</sup> makes such fiduciary law as remains much more difficult to enforce. Moreover, even as Delaware holds termination decisions open to second-guessing in the Chancellor's discretion,<sup>108</sup> other states concede business judgment treatment subject only to review of the special committee's independence and investigatory process.<sup>109</sup>

Representative plaintiffs face other new hurdles as well. Corporations now have the power to use their charters or bylaws to channel fiduciary litigation to the state of incorporation.<sup>110</sup> Here, the generating energy comes from Delaware lawmakers working in tandem with defense counsel to choke off the plaintiff's lawyers' option of bringing shareholder suits against the managers of Delaware corporations in less sophisticated, more sympathetic jurisdictions.<sup>111</sup> Delaware has also tightened review of nonpecuniary settlements of marginal fiduciary complaints, further reducing the number of cases that support evaluation as investment grade on the side of the representative plaintiff bar.<sup>112</sup>

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<sup>106</sup> See *supra* text accompanying notes 64-68.

<sup>107</sup> See *supra* text accompanying note 69.

<sup>108</sup> Other state states proceed similarly, but under different formulations. See *Cukor v. Mikalauskas*, 547 Pa. 600, 692 A.2d 1042 (1997)(following the *ALI Principles*); *In re PSE&G Shareholder Litigation*, 173 N.J. 258, 801 A.2d 295 (2002)(adding reasonableness review).

<sup>109</sup> See *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979); *Boland v. Boland Trane Assoc, Inc.*, 423 Md. 296, 31 A.3d 529 (2011).

<sup>110</sup> See *Boilermakers Local 154 Ret. Fd. v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013). Section 115 of the Delaware Code, enacted after the case provides as follows:

The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State. "Internal corporate claims" means claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery.

DEL. CODE ANN., tit 8, § 115. The line has been drawn at the shifting of attorney's fees, however. See DEL. CODE ANN., tit 8, § 102(f).

<sup>111</sup> On the shifting jurisdictional pattern, see, e.g., John Armour et al., *Is Delaware Losing Its Cases?* 9 J. EMPIRICAL LEG. STUD. 605 (2012).

<sup>112</sup> See *In re Trulia, Inc. Stockholder Litigation*, 2016 WL 270821 (Del. Ch.)(announcing that "disclosure only" settlements would no longer be approved absent certain conditions, in particular, any supplemental disclosures must address material misrepresentations or omissions, and the obtained by the defendants must be narrowly tailored to the claims relating to the disclosures).

Other adjustments are substantive and go to the standard of review, echoing the move to business judgment treatment of management self-dealing transactions. The majority-to-minority shareholder fiduciary duty, until recently, implied fairness review as of right: a showing of control or great influence on a shareholder's part triggered intrinsic fairness scrutiny of its transactions with the company.<sup>113</sup> At the same time, either delegation to an independent committee or majority-of-the-minority shareholder ratification earned a burden shift on the fairness question from the defendant to the plaintiff.<sup>114</sup> (This was the doctrinal source of the third interpretation of section 144 introduced by Chancellor Allen in *Cinerama*.<sup>115</sup>) This long-established regime has been relaxed. Under *Kahn v. M&F Worldwide Corp.*,<sup>116</sup> an appropriately structured decisional delegation to an independent committee combined with majority-of-the minority shareholder ratification can lead to business judgment review of a transaction between a controlling shareholder and the company.<sup>117</sup>

Some of what once were fiduciary mandates have evolved into default rules. Corporations may now partially negate the fiduciary duty of care with appropriate charter language blocking suits for damages.<sup>118</sup> In addition, in Delaware, the actionability of corporate opportunities can be cut off in the charter or even by a boardroom resolution.<sup>119</sup> Outside of the corporate form, in the expanding world of limited liability companies and limited partnerships, drafters can opt out of fiduciary duties entirely, limiting investors with grievances to the contract law of good faith.<sup>120</sup>

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<sup>113</sup> The Delaware courts deem a stockholder a controlling when it either owns more than 50% of the voting power of a corporation or owns less than 50% of the voting power of the corporation but “exercises control over the business affairs of the corporation.” *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1113–14 (Del. 1994). The showing of control proceeds on all the facts, and goes to the particular transaction being challenged or the corporation generally. *See Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 659 (Del. Ch. 2013) (quoting *Williamson v. Cox Commc'ns Inc.*, 2006 WL 1586375, at \*4 (Del. Ch.)). *See also In re Crimson Exploration Inc. S'holder Litig.*, 2014 WL 5449419, at \*12 (Del. Ch.).

<sup>114</sup> *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994).

<sup>115</sup> *See supra* text accompanying note 84.

<sup>116</sup> 88 A.3d 635 (Del. 2014).

<sup>117</sup> 88 A.3d at 653, confirming that the business judgment standard of review applies to a parent-subsidiary merger that cashes out minority shareholders where the merger has been conditioned upon the approval of both an independent and adequately-empowered special committee of directors and an uncoerced and informed vote of a majority of the minority stockholders.

<sup>118</sup> DEL. CODE ANN., tit 8, § 102(b)(7).

<sup>119</sup> DEL. CODE ANN., tit 8, § 122(17).

<sup>120</sup> *See* DEL. CODE ANN., tit. 8, § 17-1101(d)(opting out in limited partnerships); DEL. CODE ANN. Tit 18 § 18-1101(d)(opting out in limited liability companies). The sections were redrafted to overrule a contrary holding in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160 (Del. 2002).

Finally, there is notable contraction of what formerly were fiduciary law's late-20<sup>th</sup> century points of expansion:<sup>121</sup> *Unocal's* proportionality scrutiny of management defensive tactics,<sup>122</sup> *Revlon's* reasonableness review of certain sell-side merger decisions,<sup>123</sup> and *Blasius's* strict review of management interference with the shareholder franchise.<sup>124</sup> *Unocal* no longer matters, less because later cases bowdlerized its rule than because hostile tender offers have largely disappeared,<sup>125</sup> in part due to *Unocal's* sanctioning of the poison pill.<sup>126</sup> *Revlon*, which originally was seen to require a formal auction of the company given the fulfillment of certain conditions, gradually has been stripped down to reasonableness review of the sell-side board's information level.<sup>127</sup> *Revlon* also was seen originally as an arm of the duty of loyalty, but became disaggregated between duty of care fact patterns and conflict of interest fact patterns, with the result that duty of care opt-outs in corporate charters can block *Revlon* actions for damages.<sup>128</sup> Most recently, in *Corwin v. KKR Financial Holdings LLC*,<sup>129</sup> the Delaware Supreme Court ruled that, given a loyalty-based, post-closing action for *Revlon* damages, business judgment is the appropriate standard of review for approval of the merger by a fully informed, uncoerced majority of the disinterested stockholders. As a practical matter, *Revlon* is no longer about damages, and its zone of operation is largely restricted to suits for pre-closing equitable relief. As for *Blasius*, it never did amount to much. Its "compelling justification" review standard for interference with the franchise makes it intractable: once an impairment within the rule has been shown, the case is basically over, and the plaintiff wins. The courts accordingly have disfavored a resort to *Blasius* review. Their disfavor has been notable in recent years, for even as interference cases have

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<sup>121</sup> For an extended treatment of this topic see James D. Cox & Randall S. Thomas, *Delaware's Retreat: Exploring Developing Fissures and Tectonic Shifts in Delaware Corporate Law*, 42 DEL. J. CORP. L. 323 (2018)

<sup>122</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del.1985); *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1388 (Del.1995).

<sup>123</sup> *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

<sup>124</sup> *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del.Ch.1988).

<sup>125</sup> In the dataset of cases in the Westlaw Delaware Chancery folder reported on in Part IV *infra*, there are only four cases concerning tender offers decided since 1990.

<sup>126</sup> *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del.1985)

<sup>127</sup> See *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del.1989) (stating that there is "no single blueprint that a board must follow to fulfill its duties.").

<sup>128</sup> See *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001).

<sup>129</sup> 125 A.3d 304 (2015).

proliferated when boards have defended against activist hedge fund proxy contests, *Blasius* has not been applied.<sup>130</sup>

### C. Conclusion

Harold Marsh viewed judicial review for fairness as a second-best backstop to *per se* prohibition. He had good reasons: an intuitive cost-benefit case supported his view, and management domination of the governance system seemed to call for an emphatic prohibitory response. Today, a half century after Marsh, judicial review for fairness is no longer available for properly engineered transactions arising out of “independent” processes. Marsh likely would have viewed such a development as the functional equivalent of handing management the combination to the safe, for he did not believe that such an “independent” process could exist. His view persists in the structural bias account and the still-vital academic tradition emphasizing fiduciary law’s evolutionary erosion of fiduciary law.<sup>131</sup> Simply put, corporate fiduciary law is thought to have gone to the dogs.

The remainder of this Article reconsiders this conclusion.

## III. THE HISTORICAL COUNTER-STORY

The evolutionary erosion account rests on Marsh’s reading of the late nineteenth and early twentieth century cases. The reading was challenged during the 1990s. But in the view of most, Marsh’s reading emerged intact. We now have a new and redoubled challenge. This time the result is different, for the new challenge indubitably succeeds. This Part lays out its terms, making further reference to the early 20<sup>th</sup> century observations of Adolf Berle, who saw nothing wrong with the judicial turn-away from *per se* invalidity to fairness review, even as he certainly worried about shareholder vulnerability, given separated ownership and control.

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<sup>130</sup> In *Yucaipa America Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010), *aff’d* a5 A.3d 2318 (Del. 2011), the Delaware Chancery Court refused to apply the *Blasius* line of cases to invalidate a poison pill with a 20 percent ownership threshold promulgated to frustrate a proxy contestant. The effect of the ruling was to channel activists objecting to management defensive tactics to the more permissive Unocal standard of review. In a subsequent case, *Third Point LLC v. Ruprecht*, 2014 WL 1922029 (Del. Ch.), the Chancery Court rejected a Unocal claim brought by an activist proxy contestant against a poison pill with an innovative 10 percent ownership threshold.

<sup>131</sup> See Velasco, *supra* note 104; Cox & Thomas, *supra* note 121; Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903 (2011) (concluding that plaintiffs face excessively high hurdles of pleading and proof and recommending shifting the burdens to management).

## A. The Structural Inevitability of Fairness Scrutiny

In a pair of articles published during the 1990s, Norwood Beveridge challenged Marsh's account of the late 19<sup>th</sup> and early 20<sup>th</sup> century cases.<sup>132</sup> Beveridge showed that Marsh's description of a first phase in which *per se* prohibition reigned unchallenged was inaccurate, because cases that reviewed for substantive fairness and clean process also can be found during the first phase. Carrying this point to a logical conclusion, Beveridge asserted that a regime of absolute prohibition in fact had never existed.<sup>133</sup> Marsh, he said, had misread the invalidity cases, interpolating an absolute rule where invalidity followed from process infirmities on the facts of the case.<sup>134</sup> Subsequent commentators accepted Beveridge's point that *per se* invalidity had not held exclusive sway during phase one. But the Marsh account otherwise was left standing: absolute invalidity informed most of the cases during phase one, so the erosion account still worked.<sup>135</sup>

Professor David Kershaw has reopened this inquiry. He confirms Beveridge's point that there never was a period in which absolute invalidity reigned alone. He goes on to show what both Marsh and Beveridge deny—that absolute invalidity and fairness review co-existed during phases one and two, with fairness scrutiny only gradually eclipsing *per se* invalidity. More important, Kershaw persuasively explains the joint appearance and co-existence of the two approaches. His account denudes the history of the normative implications that so mesmerized Marsh and his successors.

The key to Kershaw's thesis is a comparative perspective. He juxtaposes this country's doctrinal evolution with that of the U.K.. The inquiry shows that the absolute prohibition rule derived from U.K. caselaw, which in the 1854 case of *Aberdeen Railway v. Blaikie* adopted a rule of voidability at the company's option in the absence of ex ante shareholder authorization or ex post shareholder ratification.<sup>136</sup> This remained the U.K. approach for long thereafter, but by no means resulted in a pristine environment free of self-dealing contracts, because U.K. shareholders proved quite willing to consent. Once transplanted to this country, the voidability rule operated in

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<sup>132</sup> Beveridge, *supra* note 105; Norwood P. Beveridge, *Interested Director Contracts at Common Law: Validation under the Doctrine of Constructive Fraud*, 33 LOY. L. A. L. REV. 97 (1999).

<sup>133</sup> Beveridge, *supra* note 105, at 659-662.

<sup>134</sup> *Id.* at 660.

<sup>135</sup> See WILLIAM L. CARY & MELVIN A. EISENBERG, CASE AND MATERIALS ON CORPORATIONS 650-651 (7<sup>th</sup> ed. 1995); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 613 n. 43 (1997).

<sup>136</sup> *Aberdeen Ry Co. v. Blaikie*, 1 Macq 461 (1854).



a materially different conceptual framework. In the U.K., incorporation imported limited liability in a legal framework otherwise dominated by partnership concepts.<sup>137</sup> Variation by contract was accepted and expected—the voidability rule was never expected actually to operate as a prohibition. The conceptual framework of incorporation was very different in the U.S., where incorporation came with mandates derived from state chartering.<sup>138</sup> Where, in the U.K., the incorporation statute empowered the shareholders to redistribute power by contract, in the U.S., corporate statutes delegated power to the board of directors without a concomitant delegation of power to vary statutory rules by contract.<sup>139</sup> The adoption of the U.K.’s voidability rule in the U.S. thus had a very different effect. In the mandatory environment of U.S. law, the voidability rule led not to self-dealing transactions based on shareholder consent, but to absolute prohibition.

Meanwhile, *Aberdeen Railway* was not the only line of U.K. law on which U.S. corporate fiduciary law could be constructed.<sup>140</sup> There were also trust and agency cases in which the fiduciary contracted with the beneficiary, subject to fairness review. Courts in this country also adapted these cases into corporate law. By analogy to the principle that a trustee could not contract with itself but could contract with the beneficiary, an officer or director could contract with the company only if the officer or director played no role in the company’s approval of the contract and the contract was fair. As we have seen,<sup>141</sup> it followed that director self-dealing transactions could be sustained if approved by a majority disinterested board with the interested director not participating.<sup>142</sup>

By 1880, both lines of U.K. precedent had found their way into U.S. corporate law. The second line eventually came to dominate. But, contrary to Marsh, there was no sudden lurch to management accommodation. It had always been wrought into the system. Nor did *Aberdeen Railway* suddenly disappear. Kershaw shows that it persisted in the law of New Jersey until 1960.<sup>143</sup>

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<sup>137</sup> KERSHAW, *supra* note 3, at 288.

<sup>138</sup> *Id.* at 288.

<sup>139</sup> *Id.* at 302.

<sup>140</sup> Kershaw also points out that fairness review shows up in the U.K. within the *Aberdeen Railway* line of cases. It happens at the damages phase of cases where a fully or partly performed contract was ruled void. The outcome of the judicial accounting depended on the fairness of the bargain. *Id.* at 326.

<sup>141</sup> See *supra* text accompanying note 13.

<sup>142</sup> KERSHAW, *supra* note 3, at 327-28.

<sup>143</sup> *Id.* at 329-41.

Beveridge's critics argued that Marsh's primary historical point remains robust, for the history remains one of erosion—the more restrictive *Aberdeen Railway* line of authority wanes as less restrictive tandem of internal process and external fairness review waxes.<sup>144</sup> This observation remains true, even in the wake of Kershaw's intervention. Evolutionary erosion is indeed fundamental to the history of American corporate fiduciary law.

Kershaw successfully realigns the story's normative implications. Marsh's oversimplification makes prohibition look natural and desirable for all concerned, other than the grasping managers themselves. It also invites an explanation for the sudden shift to doctrinal flexibility grounded in interest group capture. Under Kershaw's account, prohibition is a false step made in a process of doctrinal transplantation. For Kershaw, the baseline doctrinal dispensation builds in flexibility by allowing for the parties to process their way to beneficiary consent, subject a fairness backstop. The experiment with prohibition took a rule formulated in a flexible, contractual context and redeployed it in an inflexible, mandatory context. It was, as such, unsustainable, and its disappearance amounted to an ordinary course reversion to a doctrinal baseline. Moreover, because prohibition had always co-existed with process and fairness review (some states going one way and others going the other way), there was no sharp break, just a quiet transition. Kershaw reaches these conclusions as a strictly positive proposition. No normative punchline is wrought into his analysis.

## **B. Berle on Self-Dealing Transactions**

The writings of Adolf Berle indirectly confirm Kershaw's account. The confirmation is unexpected, for the evolutionary erosion account is a conceptual first cousin to the description of separated ownership and control that originated with Berle's writings of the early 1930s and went on to dominate thinking about corporations for rest of the 20<sup>th</sup> century. Self-dealing transactions were a problem for observers like Marsh and Clark precisely because management possessed boardroom power without accountability. They were reluctant to rely on judicial fairness review because they saw it as a part of a larger system devoted to management accommodation. One accordingly would expect to see judicial treatment of management self-dealing transactions front

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<sup>144</sup> See Velasco, *supra* note 104, at 1044.

and center in the extended discussions of fiduciary law in Berle's work in law reviews<sup>145</sup> and in Berle and Means's *The Modern Corporation and Private Property*.<sup>146</sup> But the opposite is true.

Berle certainly recognized that the management accountability problem enhanced the importance of legal fiduciary constraint. With growing separation, he wrote, legal enforcement of the constraint and the shareholder franchise were the *only* things left that assured shareholders of expected positive returns. Take them away, and shareholders would be left entirely at the mercy of the manager's good nature.<sup>147</sup> Berle saw plenty of problems with the fiduciary regime. But the duty of loyalty, as applied to self-dealing transactions, was not one of them. To the contrary: "The law governing the duties of management towards security owners is perhaps the only section of corporate jurisprudence which has not undergone a sustained weakening process."<sup>148</sup> Berle acknowledged that there were two lines of authority on the books, *Aberdeen Railway* voidability and process plus fairness review.<sup>149</sup> But he didn't think that much rode on the choice between the two. It was an area where the common law had a "flexible and realistic" quality and judges did a good job when applying the law, usually finding a solution when the facts demanded remedial action.<sup>150</sup>

Berle did see problems stemming from zones of management discretion that had opened up as a result of statutory liberalization and charter-based modifications of statutory defaults. He identified five areas of likely abuse: (1) the power to issue (and set the terms of) new shares of stock;<sup>151</sup> (2) the power to declare or withhold dividends;<sup>152</sup> (3) the power to buy stock in other

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<sup>145</sup> Here A. A. Jr. Berle, *Corporate Powers As Powers in Trust*, 44 HARV. L. REV. 1049 (1931), is the leading contribution.

<sup>146</sup> ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Macmillan reissue 1933).

<sup>147</sup> *Id.* at 196-97.

<sup>148</sup> *Id.* at 197.

<sup>149</sup> *Id.* at 198-99, n 4.

<sup>150</sup> *Id.* at 197. Berle was similarly content with the law of majority-to-minority fiduciary duties. *Id.* at 212-213. He only found fault with the treatment (or, better, nontreatment) of sale of control transactions. It is true that *The Modern Corporation* warned about management "plundering," but the warning is incident to a future projection. It was thought experiment: Suppose the pattern of separation was extended further out to a logical conclusion point and corporate investors continued their pattern of acceding to any requested modification of the corporate charter that had the effect of according management more power. The result would be a management power to divert corporate income to its own use. What should we do then? There two alternatives: either tamp on management by imposing trust duties even though there might be a countervailing cost, or give management free rein and accept the risk of plundering. *Id.* at 311. At the bottom line there were two points. The hypothesized plundering should be controlled even as rights should be recognized in constituents other than the shareholders. *Id.* at 312.

<sup>151</sup> Berle, *supra* note 145, at 1052-1059.

<sup>152</sup> *Id.* at 1060-1063.

corporations and use ownership of blocks of stock to entrench management;<sup>153</sup> (4) the power to amend the corporate charter by majority vote and thereby injure the interests of minority classes of stock;<sup>154</sup> and (5) the power to transfer corporate assets and control in mergers.<sup>155</sup> Surveying instances of abuse across the five topics, Berle made his famous suggestion that the exercise of corporate power should be subject to an equitable limitation of exercise for “the ratable benefit of all the shareholders as their interest appears.”<sup>156</sup> All corporate actions should be “twice tested: first for technical compliance with the law pursuant to which corporate powers are created and then under the equitable standard.”<sup>157</sup>

Today, only one of Berle’s five topics—mergers and acquisitions—arouses policy concerns regarding the shape and application of the duty of loyalty. The third topic, defensive cross-corporate block ownership, was dealt a death blow in the Delaware courts back in 1967.<sup>158</sup> In the other three areas—new stock issues, dividend policy, and equity recapitalizations—management discretion still rules and the equitable concerns that motivated Berle motivate few decisions today.<sup>159</sup> The fact patterns continue to lie largely in business judgement territory, with investors largely left to fend for themselves.

### C. Summary

Let us reconsider the fourth phase of erosion of fiduciary scrutiny in light of Kershaw’s historical counter-story. The fourth phase now can be recast as a reversion to historical form. In phases one and two, we had mandatory review by disinterested directors, backed by fairness scrutiny. In phase four, we have a variation on that theme—a choice between review by independent directors and fairness scrutiny. Phase three (fairness scrutiny across the board without process scrutiny) emerged as a break in the pattern, a break that paired with the phase one experiment with prohibition. Deep skepticism about the quality of boardroom decision-making motivated both breaks. Part IV will show that the skepticism is now on the wane.

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<sup>153</sup> *Id.* at 1063-1065.

<sup>154</sup> *Id.* at 1066-1069.

<sup>155</sup> *Id.* at 1069-1073.

<sup>156</sup> *Id.* at 1049.

<sup>157</sup> *Id.*

<sup>158</sup> See *Condec v. Lunkenheimer Co.*, 230 A.2d 769 (Del. Ch. 1967) (finding a breach of duty in a keiretsu-type stock swap undertaken in defense of a hostile tender offer).

<sup>159</sup> The author is one of the few. See William W. Bratton & Michael Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815 (2013).

## IV. SELF-DEALING TRANSACTIONS IN TODAY'S CORPORATE GOVERNANCE SYSTEM

This Part reconsiders the evolutionary erosion account's present normative implications, reversing the conclusion that erosion is a problem. The reversal follows from reference to developments in practice. In its fourth phase, evolutionary erosion of fiduciary doctrine was accompanied by the evolutionary emergence of a governance system capable of making managers accountable and tilting the boardroom balance against self-dealing transactions. It accordingly is not at all clear that the erosion implies significant shareholder injury. Nor is it clear that public company shareholders continue to need as of right fairness scrutiny, much less *per se* prohibition, for the governance system now works well enough to let them take care of themselves. Ironically, continued and constant aversion to self-dealing is the key motivation.

Section A briefly recounts the story, now familiar, of the shift of power from entrenched managers to independent boards and market shareholders. The account takes us from the biased and enervated board observed by Marsh and Clark to the more vigorous, majority-independent monitoring board that we see today, and from the helpless shareholders of the era of separated ownership and control to today's institutional masters of the corporate universe.

Section B turns to the present corporate governance environment, showing how regulation makes it an unfriendly place for self-dealing transactions. There are two means to this end: mandatory disclosure and director independence standards that are undercut by a self-dealing on the side. Norms operative within corporations are even stricter than the regulation—this Article's survey of recent proxy statements shows near universal adherence to a norm favoring supermajority independent boards.

Section C adds detail to this practice picture, reviewing a sample of recent proxy statement disclosures of self-dealing transactions. There is a plethora of transactions reported, almost all of them small and highly unlikely to excite shareholder concerns. Only two big deals show up in the 93 proxy statements in the group, both of which can be explained away institutionally as outliers. Concerns about slack devolve on a subset of controlled companies, which make up 10% of the sample.

Section D enhances the picture of self-dealing transactions at controlled companies by reviewing the prospectus disclosures of 50 companies that completed initial public offerings (IPOs) during the fall of 2019. Ninety-six percent of the companies in this sample are either controlled by founders and VCs (whether separately or jointly) or by a majority-holding operating parent. Self-dealing contracts show more economic salience in this subset, even as there is also evidence that normative constraints in their disfavor register even here. Blockholder self-dealing is wrought into issuer business plans only in the majority parent-subsidary subset.

Section E turns to the litigation environment and a collection of 512 duty of loyalty litigations commenced in the Delaware Chancery court since 1985. A survey of the reported complaints shows that the classic self-dealing transaction on which Marsh focused is no longer a salient litigation topic, at least from a policy point of view. There are still plenty of cases featuring self-dealing but they tend to come up in the information enriched and heavily regulated context of mergers and acquisitions.

Part IV concludes that, given separation of ownership and control, regulatory constraints (disclosure and independence rules) work together with systemic normative constraints effectively to discourage self-dealing contracts. Normative constraints appear to suffer dilution in controlled companies, and continued vigilance in monitoring remains advisable in the sector.

### **A. The Emergence of the Independent Board and the Power Shift**

When Marsh published in 1966, the concept of corporate governance did not yet exist. It was invented soon thereafter—the term first appeared in the press in 1972.<sup>160</sup> The first fully developed text on the subject, Melvin Eisenberg’s *The Structure of the Corporation*,<sup>161</sup> followed in 1976. Eisenberg synthesized and advanced a generation of thinking about deficiencies of the received legal model of the corporation.<sup>162</sup> For a corrective mechanism, he turned to the board of directors,<sup>163</sup> long thought to be moribund. His theory was that, if we scaled down the demands we placed on it and successfully required it to monitor management performance (as opposed to taking

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<sup>160</sup> See Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. Corp. L. 359, 373 (2016) (“[T]he New York Times featured the phrase as early as 1972.”).

<sup>161</sup> MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1976). Eisenberg’s monitoring model of the board of directors has ever since been the main focus of legal corporate governance.

<sup>162</sup> See *generally id.* (discussing additional rules and structure for corporate governance).

<sup>163</sup> See *id.* at 139–85 (discussing additional structure for board of directors and management).

a leadership role in hands on management), corporate performance would improve.<sup>164</sup> This monitoring function in turn required independent directors and a committee structure keyed to monitoring functions.<sup>165</sup> Eisenberg's monitoring model quickly came to the fore in policy discussions and retained its center stage position when, in succeeding years, the microeconomic concept of agency costs<sup>166</sup> came into circulation as the diagnostic base for problems stemming from separated ownership and control. Independent boards meant agency cost reduction and, hence, shareholder value enhancement.

The monitoring board of directors was still very much a work in progress when Dean Clark published in 1986. Management had tried to capture the new thing called "corporate governance" in the late 1970s, attempting to mold it for its own purposes before some competing interest could do so in a more intrusive way. Thus did *Business Roundtable* in 1978 publicly embrace the independent director majority.<sup>167</sup> It figured that any threat to its members' privileges was minimal so long as incumbent CEOs could use their influence to secure appointment of cooperative types in independent slots.<sup>168</sup> Cooperative engagement by management did not last long, in any event. The 1978 concession was a preemptive strike launched in response to post-Watergate regulatory initiatives. When the threat of new regulation receded after 1980, management reverted to its accustomed role of opposition to corporate governance reform. It fought tooth and nail when the American Law Institute geared up to propose independence mandates in the 1980s.<sup>169</sup> Meanwhile, the markets had suddenly shown up at governance's front line—hostile tender offerors were using the free market in shares to throw managers out onto the street. We can see now, with the benefit of hindsight, that the markets' position in corporate governance has been steadily solidifying ever since.<sup>170</sup> But that outcome was far from clear in 1986, when most observers feared that

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<sup>164</sup> See *id.* at 156–57 (discussing the function of the board of directors).

<sup>165</sup> See *id.* (emphasizing the monitoring function of the board).

<sup>166</sup> The source was Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

<sup>167</sup> See *Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2085, 2089, 2093 (1978) (proposing reforms to encourage more independent directors).

<sup>168</sup> See Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 610–612 (1982) (describing the pattern of cooperation and management control of appointments).

<sup>169</sup> See Victor Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223, 228 (1983) (opposing increased government regulation of board structure).

<sup>170</sup> See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 655, 676 (2010) (“[M]anagers emerged from the 1980s sensitized to the benefits of shareholder-value maximization even as the board of directors emerged as a more robust monitoring institution. Hostile takeovers

management could and would use its lawmaking influence to defuse the market threat. When the takeovers really did stop, after 1989, it was indeed the ostensible result of collaboration between managers and state lawmakers to deter takeovers with legal barriers.<sup>171</sup>

Management won the regulatory battle against takeovers only to lose the governance war in the long run. The system adjusted to the reversal of the hostile takeover in significant respects, finding new ways to reduce management agency costs in a dynamic process operating both inside corporate hierarchies and outside in the market.<sup>172</sup> Managers emerged from the takeover era sensitized to the benefits of shareholder value maximization.<sup>173</sup> The board of directors simultaneously emerged as a more robust monitoring institution. Together, managers and boards used equity compensation plans to redirect management incentives in the shareholders' direction.<sup>174</sup> There was also a steady stream of input regarding governance practices from shareholders, now capable of making their voices heard due to the trend toward holding by institutional investors. Although precatory rather than directive, the inputs were not without effect,<sup>175</sup> figuring into a general movement to use process to push companies away from CEO dominance to greater responsiveness to market demands. Movement to a majority independent board was a focal point.

What started as shareholder governance input evolved into governance dominance when activist hedge funds appeared after the turn of this century. Their success at shaping business plans showed that the shareholder collective action problem is not as preclusive as had been assumed. Commentators had long bemoaned the absence of disciplining blockholders in the U.S. shareholder population.<sup>176</sup> With the activist hedge funds, we finally developed a home-grown

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lost their place at the cutting edge of corporate governance as a result.”).

<sup>171</sup> See Edward F. Greene, *Regulatory and Legislative Responses to Takeover Activity in the 1980s: The United States and Europe*, 69 TEX. L. REV. 1539, 1542 (1991) (“The desire by both management and state legislators to curb hostile takeovers placed the courts in a difficult dilemma.”).

<sup>172</sup> The groundwork has been there for all to see for many years. See Kahan & Rock, *supra* note 29, which describes the changes as adaptive and stresses that they have followed from bilateral cooperation between shareholders and managers.

<sup>173</sup> Bratton & Wachter, *supra* note 170, at 677-78.

<sup>174</sup> *Id.* at 678.

<sup>175</sup> Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 (2016) (suggesting that passive mutual funds influence firms' governance choices, resulting in more independent directors, removal of takeover defenses, and more equal voting rights).

<sup>176</sup> See MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 223-24 (1994); Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 1006-09 (1993). It turned out that the incentives that supported blockholding abroad could not be replicated domestically. Path dependencies



variant. The hedge funds tell managers how to realise value and challenge publicly those who resist the advice, successfully using the proxy contest as a threat.<sup>177</sup> The threat has proved credible: hedge fund designees have entered boardrooms in large numbers, all without any change in the legal model. The difference lies in the economics of their shareholding and has to do with institutional incentive alignment.<sup>178</sup> The hedge fund strategy has proved successful overall<sup>179</sup> and appears to be a permanent force in corporate governance.

Power has shifted to the shareholders as a result. The market (that is, dispersed investors) now often determines production decisions. The system channels shareholder inputs into business decision-making through the electoral franchise—managers must attend to shareholder demands because activist investors can credibly threaten to intervene directly in target firm governance by gaining board representation through a proxy contest.<sup>180</sup> The process of threat and response is dynamic—rational managers accede to activist demands concerning the business plan or modify their business plans in anticipation of such demands. Meanwhile, the appearance of the hedge funds triggers other changes in the system. Managers, now on the defensive, voluntarily remove longstanding process barriers to shareholder inputs as they cater to the shareholder side. Even mainstream investment advisors,<sup>181</sup> formerly thought to be allergic to governance intervention, now take a more aggressive posture.

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within the system retarded its adaptability. At the same time, blockholding in other countries followed from their different political environments, in particular their stronger social democratic systems.

<sup>177</sup> The hedge funds take significant equity stakes in target companies—5 to 15 percent of the stock is the range—and demand new value realization in the near or intermediate term. They pursue the financial items that sit at the top of the standard agency cost reduction agenda—increased leverage, payouts of excess cash, premium asset sales, and cost cutting. William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L. J. 1375, 1390-1401 (2007).

<sup>178</sup> *Id.* at 1384. Hedge funds are independent actors, where other institutional investors are not. They do not sell services to the class of companies they target, and so, unlike conventional mutual fund advisors, are unconflicted. *Id.* at 1384. But they depend on, and have received, the support of other, more passive institutional investors. See Ronald J. Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865-67 (2013).

<sup>179</sup> See, e.g., Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1739-45 (2008).

<sup>180</sup> For empirical studies of incidence, tactics, and success, see Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 188 (2009); Nikolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610 (2013).

<sup>181</sup> See William W. Bratton & Simone Sepe, *Corporate Law and The Myth of Efficient Market Control*, 105 Cornell L. Rev. 675, 726 (2020).

As with the earlier emergence of independent boards, the power shift occurred at the level of practice rather than as a function of regulatory mandate. The move to independence resulted from joint efforts by directors and investors to institute best corporate practices.<sup>182</sup> Mandates concerning board composition did come in the form of stock exchange rules mandating a majority independent board and independent committees,<sup>183</sup> but they came after the fact, in the wake of the Enron debacle of 2001. Hedge fund activism emerged as a function of the evolution of a lightly regulated form of investment management, a form that produced fund managers with incentives suited to pursue governance intervention as an investment strategy.

This does not go to say that regulatory innovations have been irrelevant. The 1994 amendment of the proxy rules to permit short candidate slates<sup>184</sup> laid advance groundwork for the activists. The 2003 imposition on investment advisors of a duty to vote portfolio shares on a considered basis and in the beneficiary's best interests<sup>185</sup> similarly eased their way by depriving management of a built-in base of voting support. The voting rule also prompted the appearance of powerful informational intermediaries like ISS and Glass Lewis, who met a sudden demand for voting advice emanating from smaller advisors for whom internal decision-making on voting was not cost effective.

## **B. Self-Dealing Transactions: Disclosure Mandates and Inconvenient Consequences**

We turn to the place taken by the classic self-dealing transaction in today's shareholder-oriented governance system.

Assume that today's shareholders are as allergic to self-dealing transactions as were Professor Marsh and Dean Clark—that they similarly weigh the costs and benefits and reach the same negative result. Given that assumption, is it plausible to suggest that self-dealing transactions

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<sup>182</sup> The emergence of the independent board did occasion some pushing and shoving in the private sector, manifested in the gestation of the ALI corporate governance project. See Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212, 1218 (1993) (describing the conflicting views between the ALI and corporate management).

<sup>183</sup> N.Y. Stock Exch., NYSE Listed Company Manual, 303A.01 (2020), [https://nyse.wolterskluwer.cloud/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS\\_TAL\\_5667%23teid-66](https://nyse.wolterskluwer.cloud/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-66) (last visited Dec. 16, 2020). Not only is an independent director majority now mandated, but independence is defined formally. *Id.* ¶ 303A.02. Accompanying mandates include separate meetings for outside directors, and all independent nominating, compensation, and audit committees. *Id.* ¶¶ 303A.03, .303A.04, 303A.05, 303A.06 (2019).

<sup>184</sup> See SEC, Securities Exchange Act of 1934 Rule 14a-4(d)(4), 17 CFR § 229.14a-4(d)(4)(2019).

<sup>185</sup> See SEC, *Proxy Voting by Investment Advisors*, 17 CFR Part 275, Release No. IA-2106 (March 10, 2003).

could amount to a systemic problem in public companies with dispersed shareholders? It is difficult to imagine how the problem could persist. If self-dealing transactions rub shareholders the wrong way, then one would expect them to go the same way as staggered boards and plurality voting, with management voluntarily taking them off the table as management caters to institutional investors and informational intermediaries. Indeed, it is an easy accommodation for managers to make. When Marsh published back in 1966, managers took most of their remuneration in the form of salary, a salary set on a grid that tied theirs to that of the rest of the employees.<sup>186</sup> In that context, a self-dealing transaction, much like insider trading, would have served as an indirect means of getting a raise. The shift to equity-based compensation removes the need for this subterfuge. The governance system, meanwhile, builds in two significant disincentives—transactional disclosure and loss of independent status.

Today's self-dealing transactions are effected in plain view, at least so long as a reporting company wants to stay in compliance with federal law. The annual proxy statement is required to disclose, pursuant to Regulation S-K item 404, transactions in an amount exceeding \$120,000 between the company and, *inter alia*, board members, executive officers, and members of their immediate families.<sup>187</sup> The company also has to disclose its “policies and procedures for the review, approval, or ratification of any transaction required to be reported.”<sup>188</sup> The regulation suggests that the transactions covered, the standards to be applied, and the very existence of a written policy all might be matters material to the annual report.<sup>189</sup>

When a self-dealing transaction involves a director, the director loses independent status. The New York Stock Exchange here applies the same \$120,000 test as does Regulation S-K and goes on to pick up interlocks between the company and entities connected to the director and his or her immediate family members, defined in terms of payments within three years in an amount exceeding the greater of \$1 million or 2 percent of the interlocked entity's gross revenues.<sup>190</sup> The NASDAQ Rule proceeds similarly, raising the interlock test to \$200,000 and 5 percent.<sup>191</sup> Under both sets of rules, loss of independent status means that the director no longer qualifies for the

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<sup>186</sup> See GERALD F. DAVIS, *THE VANISHING AMERICAN CORPORATION: NAVIGATING THE HAZARDS OF A NEW ECONOMY* 131-34 (2016).

<sup>187</sup> SEC, Regulation S-K, item 404, 17 CFR § 229.404(a)(1) - (Item 404) (2019) (transactions with related persons, promoters and certain control persons).

<sup>188</sup> *Id.* § 229.404(b)(1).

<sup>189</sup> *Id.*

<sup>190</sup> NYSE Listed Company Manual, *supra* note 183, ¶ 303A.02(b)(ii), (b)(v).

<sup>191</sup> NASDAQ, Rulebook - The Nasdaq Stock Market, Rule 5605(a)(2) (2009).

majority minimum and may not serve on any of the audit, compensation, or nominating committees.<sup>192</sup> Non-independent status can also have a negative knock-on effect—a loss of votes for management’s slate at the annual meeting. The proxy advisory services, ISS and Glass Lewis, articulate their own independence standards and represent that they do their own independence checks.<sup>193</sup> They also up the ante on the stock exchange rules—ISS lowers the transactional threshold to \$10,000; Glass Lewis wants a two-thirds independent board. Neither advisor articulates separate rules defining and prohibiting self-dealing transactions, instead dealing with the matter within the framework of the independence determination.

How much of a deterrent to self-dealing results? Loss of independent status is a big deal, for the prevailing best-practice norm pushes companies to be well above a one-half or two-thirds majority. Data collected in connection with this Article<sup>194</sup> comes from the most recent proxy statements from the 31 companies in the Dow Industrial Average, 31 companies in the S&P midcap 400<sup>195</sup> and 31 companies in the S&P small cap 600.<sup>196</sup> All of the Dow companies, all but one of the midcap companies, and all but four of the small cap companies reported super-majority independent boards. More particularly, the companies have an all independent board but for either one seat (held by the CEO) or two seats (held by the CEO and chief operating officer). The single exception in the midcap group, with a bare independent majority, is a real estate development company that operates in a single state and makes close relationships with local financial interests, including transactional ties and board interlocks, an upfront part of its business plan. In the smallcap group, three of the four exceptions have two-thirds majority independent boards. The one outlier is a controlled company—a company with a dual-class common capital structure and a founder and his family holding 65 percent of the voting power and occupying one-half of six board seats. (The company takes advantage of a NASDAQ exception to the majority independence rule for a defined class of controlled companies.<sup>197</sup>)

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<sup>192</sup> NYSE Listed Company Manual, *supra* note 183, ¶¶ 303A.05, 303A.06, and 303A.07; NASDAQ Rule 5605(c), (d), and (e) (2009).

<sup>193</sup> ISS, U.S. PROXY VOTING GUIDELINES 9-10, <https://www.issgovernance.com/file/policy/.../US-Voting-Guidelines.pdf>; GLASS LEWIS, POLICY GUIDELINES 5, 7, <https://www.glasslewis.com/guidelines/>.

<sup>194</sup> The spreadsheets are available on request addressed to this Article’s author. The exercise is inspired by a survey of the Dow companies conducted by Beveridge. *See* Beveridge, *supra* note 105, at 13. Beveridge concluded that self-dealing transactions retained economic salience. The spreadsheets are available on request addressed to the author.

<sup>195</sup> This sample included the ten largest companies in the index and 20 arbitrarily selected companies.

<sup>196</sup> This sample was arbitrarily selected.

<sup>197</sup> NASDAQ, Rulebook - The Nasdaq Stock Market, Rule IM 5615-5 (Mar. 12, 2009).

Given the supermajority norm, there is no room for large self-dealing transactions between nonexecutive directors and their companies. Now that all nonexecutive directors must be independent, a significant self-dealing transaction is intrinsically disqualifying. This barrier does not obtain as regards the top officers, as to whom independence is not a possibility. But, as the next section shows, normative constraints also come to bear on non-independent executives.

### C. Transactions

To get a better sense of the practice, consider the disclosures of self-dealing transactions in the 93 proxy statements. Separation of ownership and control is the norm across the sample—almost 90% of the companies lack a controlling blockholder<sup>198</sup> or parent, with their officers and directors as a group almost always owning less than 2% of the stock.<sup>199</sup> Although blockholders with stakes above 5% are ubiquitous, the overwhelming majority are passive asset managers like Blackrock and Vanguard. The sample contains ten controlled exceptions to the rule of separated ownership and control. Of these, two are Dow companies (Walmart, where the founder’s family retains a majority, and WalgreensBoots, where the CEO holds a 15.3% block), two are midcap companies (with family blocks of 47% and 22%), and six come from the smallcap sample (three companies with dual class capital structures and founder control, and three companies with large CEO blocks of 46%, 32% and 20%, respectively).

All but one of the companies in the sample<sup>200</sup> report internal procedures that draw on the SEC’s disclosure regulations and the exchanges’ independence standards to define self-dealing transactions. The company policies refer any proposed transaction falling into the definition to either to an independent corporate governance committee, to the audit committee, or to the full board for a determination as to whether the transaction is in the company’s best interests or, alternatively, to review the transaction’s compliance with elaborate guidelines. A handful of companies report more informal modes of treatment—for example, reference to general counsel.<sup>201</sup>

We now turn to the companies’ reports of particular transactions. The modal report, made by 37% of the companies, was that there were no reportable transactions. This response is twice

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<sup>198</sup> See *supra* note 7 for the parameters used in identifying a controlling blocker.

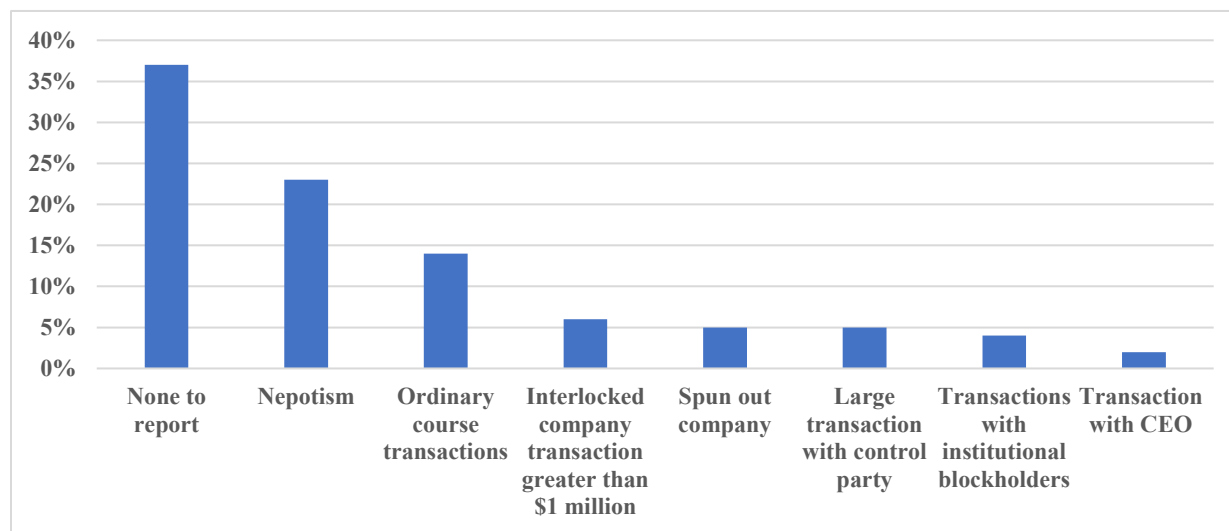
<sup>199</sup> There is one exception to this rule in the Dow sample (Nike at 10%); there are five exceptions in the midcap sample where there is no controlling blockholder and the officers and directors own more than 5%, and four exceptions in the small cap sample.

<sup>200</sup> The single exception is in apparent violation of the proxy rules.

<sup>201</sup> For a more thorough-going report on this corner of governance practice, see Tuch, *supra* note 6, at 995.

as likely in the mid- and smallcap sectors. The most common transaction reported is nepotistic hiring—a child, in-law, spouse, or sibling of a director or officer working at the company and earning more than \$120,000. This is more likely to happen at bigcap companies, 52% of which reported such arrangements. The practice is not pretty to look at, but hardly a shareholder concern, because the jobs are not at the top, and the reported compensation figures are not large.<sup>202</sup> A

**Figure 1. Self-Dealing Transactions at Listed Companies**



number of the additional categories of reported transactions are manifestly benign: 14% of the companies entered into ordinary course transactions in commodified goods with directors and interlocked partners (including bank loans); a number of companies retained contractual ties with spun-out companies; and institutional blockholders, Vanguard and Blackrock principally provided services to a number of companies. There also were three corporate jet expense-sharing arrangements. These would earn a negative voting recommendation from Glass Lewis,<sup>203</sup> but are unlikely to excite the particular companies’ shareholders, for once again, the numbers are not large.

<sup>202</sup> The author’s sense is that nepotistic hiring is statistically less likely to occur at Dow companies than it is to occur in hiring of law school faculty and administration.

<sup>203</sup> See Glass Lewis, *supra* note 187, at 20.

A handful of transactions were large enough to require a closer look, using \$1 million as a materiality threshold.<sup>204</sup> These include six cases of noncommodified transactions with interlocked companies. Goldman Sachs reported one such relationship, but it amounted to less than 0.01% of the revenues of the counterparty. JPMorgan Chase reported a \$32 million real estate redevelopment project with a company in which a director (who was not participating in the transaction) indirectly held a 10% interest. There were three interlocked transactions in the midcap group, but none of them amounted to 2% of the reporting company's revenues.

There were five cases of contracts over \$1 million with a control party or large blockholder also serving as a top executive. One of these was at a Dow company, WalgreensBoots, which owns 9% of an Italian pharmacy chain controlled by Stefano Pessina, who also serves as WalgreensBoots's CEO and reports ownership of 15.4% of its stock. Here, finally, we have a classic, suspicious self-dealing situation at a large company. Even so, these arrangements did not originate in our governance system—they came into the Dow group from another national governance system by means of a series of cross-border acquisitions. The second of the five cases is in the midcap group and amounts to only 0.15% of the reporting company's annual revenues. As to the three in the smallcap group, one is barely over this Article's \$1 million materiality threshold. The second is a lease amounting to 0.5% of the reporting company's revenues. Only the third transaction implicates numbers which by themselves might give pause. But it turns out not to be suspicious in the particular circumstances, for the company is a captive REIT whose business model is grounded in the purchase of properties from a controlling real estate development firm.

How much of a problem do the self-dealing transactions, reported by the companies in this dataset, present? With the exception of WalgreensBoots and the captive REIT, we are talking about a small number of small-numbers transactions. Significantly, the few red flags that do go up in the sample do so at controlled or heavily influenced companies. Given *separated* ownership and control, self-dealing transactions have, for all intents and purposes disappeared, other than for the hiring of relatives at big companies and the purchase of services from Vanguard and Blackrock.

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<sup>204</sup> The \$1 million tripwire is arbitrary and chosen by the author rather than derived from applicable regulations. There were reported transactions between two CEOs and their companies, but both were considerably less than \$1 million in amount.

Meanwhile, one assumes that the CEOs look to their compensation plans as the source of internal value extraction.

Let us return to the starting point and draw an inference from the fact pattern: a norm against self-dealing transactions now comes to bear internally. It stems from the same judgment that motivated Marsh and Clark: self-dealing transactions are not cost beneficial from the point of view of equity investors. The norm is closely conceptually related to the norm that favors supermajority independent boards. Both norms, although buttressed by regulation in the form of disclosure rules and independence mandates, appear to carry considerable force of their own.

#### **D. *Caveat: Control Parties***

A notable tie connects the red-flag transactions in the proxy statements and the 10% minority of controlled companies in the sample. The tie is intuitive—control and self-dealing have deep (and historic) ties. The point was brought home yet again in the press in the fall of 2019, when the financial community focused on the preliminary prospectus of a high-flying startup, We Co., the parent of WeWork. Attention focused most keenly on the sale of the putative trademark in “we” to WeWork for \$5.9 million by We Holdings LLC, an alter ego of We’s founder and 30% owner, Adam Neumann.<sup>205</sup> The transaction shocked observers as much for the brazenness of the intellectual property grab as for the corruption implicit in the \$5.9 million consideration. It was by no means the only self-dealing arrangement detailed in the SEC filing. Neumann bought properties for his own account and simultaneously leased them to WeWork, all while borrowing money from WeWork at low interest rates. There was nepotism as well. WeWork hired Neumann’s spouse (as chief brand and impact officer), his brother-in-law who was a soccer player (as “wellness” officer), and another family member (in connection with the annual “Creator Awards,” a live pitch competition with celebrity judges).<sup>206</sup> The negative inspection prompted by Neumann’s self-dealing quickly spread to WeWork’s business model. The dominoes fell in the wake of the scrutiny—the public offering was scrapped, and Neumann was terminated as CEO.

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<sup>205</sup> Ellen Huet, *WeWork Gave Founder Loans as It Paid Him Rent, IPO Filing Shows*, BLOOMBERG (Aug. 14, 2019), <https://www.bloomberg.com/news/articles/2019-08-14/wework-gave-founder-loans-as-it-paid-him-rent-ipo-filing-shows>.

<sup>206</sup> *Id.*



The company went on life support<sup>207</sup> even before the Covid-19 crisis deflated the demand for its product. In the long run there may not be much “there” there at WeWork.

The WeWork story by itself forecloses any possibility that this Article could close with a generalization to the effect that “self-dealing transactions are no longer a problem.” The spectacle of pervasive self-dealing corroding a big-ticket enterprise gestated with venture capital (VC) raises fundamental questions about the governance system—this is, after all, a context supposedly characterized by high-intensity monitoring and disciplinary intervention by blockholding shareholders. But the WeWork crack-up also has a brighter side—it seems that the pre-IPO inspection process is sensitive to governance defects and insistent as regards their repair. It is also allergic to some self-dealing transactions.

For present purposes, the question is whether WeWork was typical of today’s IPO companies or was an outlier. To answer this question, prospectuses filed in connection with the IPOs of 50 domestic companies successfully completed between June and December 2019 have been reviewed. Based on this sample, there is a clear answer respecting WeWork: it was indeed an outlier. The takeaway concerning self-dealing more generally is mixed. Startups go public as controlled companies and, as such, are burdened by self-dealing transactions absent in the case of seasoned issuers with dispersed shareholders. At the same time, there is evidence that norms favoring independence and discouraging self-dealing have an effect even at controlled startups.

Seventy-six percent of the companies went public with the founder, the VCs, or the founder and the VCs together holding more than 50% of the voting stock. In another 6% of the IPOs, the founder and VCs controlled between 20% and 50% of the stock. In addition, 10% percent of the companies came out of a controlling parent (whether by secondary offering or by spinoff). The remaining 8% of the IPOs took various profiles—one was a secondary offering by a controlling family; there was a captive REIT; and there was an IPO by a private equity investee. In only two cases out of 50 did the company emerge from the IPO with separated ownership and control.

Most of the VC IPOs, which made up 82% of the sample of 50, went public without reporting significant self-dealing transactions between the company and their founders, VCs, and

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<sup>207</sup> Carrie Monahan & Sheila Dang, *WeWork Still on Life Support, Rivals Say It Must Cut Costs Fast*, REUTERS (Nov. 5, 2019), <https://www.reuters.com/article/us-wework-survival-analysis/wework-still-on-life-support-rivals-say-it-must-cut-costs-fast-idUSKBN1XF2GM>.

other officers and directors (other than those always incident to VC financing structures). More particularly, 46% of the VC IPOs had no transactions to report, while an additional 17% reported significant contracts that had been either terminated or were otherwise wound down in advance of the offering. At the same time, 37% of the VC companies went public with self-dealing transactions in place—sales, leases or sharing arrangements of real property and intellectual property, company borrowings, and paid advisory relationships. None of the ties, however, rose to WeWork proportions or otherwise appeared as fundamental to the business model. The story was different at the controlled subsidiaries, where contractual ties to the parents remained extensive and tight. Across the entire sample, nepotism was reported at only three companies. Finally, the supermajority board independence norm holds amongst the VC startups, despite the pervasiveness of blockholding. Things work differently in the controlled subsidiaries, where most of the issuers take advantage of NASDAQ’s controlled company exception to the majority independence rule.<sup>208</sup>

The IPO companies, viewed overall, offer a mixed picture of self-dealing at controlled companies. There is evidence that the governance norm disfavoring self-dealing does indeed affect these companies—the tendency to unwind internal contractual ties before the offering testifies to this. But the inference also arises that the norm’s intensity diminishes in controlled environments, losing the reliable aspect it now carries given dispersed shareholding. No regulatory emergency is indicated, even as these situations continue to call for scrupulous monitoring.

## **E. Litigation**

As a final check on our working hypothesis concerning self-dealing transactions—that they no longer present a salient drag on shareholder value at public companies where ownership and control are separated—a survey of Delaware fiduciary litigation was conducted. The dataset contains every case that led to an opinion posted in Westlaw’s Delaware Chancery Court folder that contained the phrase “duty of loyalty.” The opinions brought up by the search term were culled into a subset of cases containing allegations of breach of the duty of loyalty. Where, as

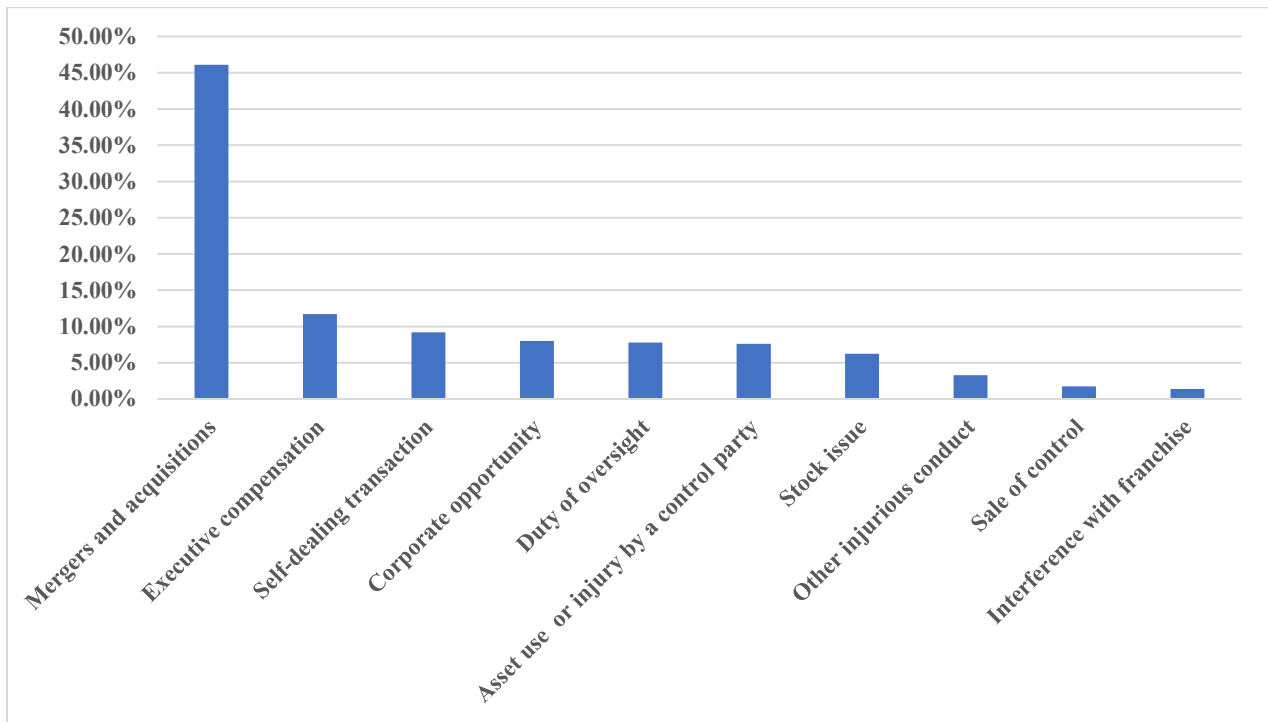
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<sup>208</sup> All but two of the companies followed the CEO only or CEO plus one practice.

often happens, a litigation leads to more than one opinion, the first opinion is the one in the dataset. The dataset begins in 1985<sup>209</sup> and ends on June 30, 2019. It sweeps in 512 separate litigations.<sup>210</sup>

A survey of the cases shows that in Delaware today, claims made based on the duty of loyalty tend to concern mergers and acquisitions. These comprise 46.1% of the reported litigations. Within that group, 81.7% concern sell-side shareholder claims. Only 16 of the merger cases concerned hostile tender offers, and only one of that group occurred in this century.

**Figure 2. Subject Matter of Delaware Duty of Loyalty Litigation, 1985-2019**



<sup>209</sup> The folder contains only three cases decided before 1985.

<sup>210</sup> Some lines were drawn. Claims for officer and director indemnification are not included; actions seeking access to books and records to verify a suspected breach of the duty of loyalty are included.

The salience of merger litigation is unsurprising. For present purposes, its importance lies in the light that it sheds on Marsh and Clark’s policy initiative. The law of M&A, like the law of executive compensation (which is the second largest subject matter group, at 11.7%) is not a territory conducive to policing by prohibition. Given a merger, a sell-side shareholder premium is on the table even when the merger involves self-dealing by sell-side actors, so the costs and benefits favor considering the deal despite the taint. Dangers due to self-dealing are dealt with through internal process protections—special negotiating committees and shareholder votes under mandatory disclosure—with judicial scrutiny as a backup. Empirical studies of litigation volume suggest that self-dealing in the fact pattern can be expected to trigger a challenge in court.<sup>211</sup>

The cases were sorted to put M&A cases on one side of a line and all other cases on the other. On the non-acquisition side, there were 47 cases (9.2% of the total dataset) concerning classic self-dealing transactions that would fall within the scope of section 144. Of these, 13 (27.7% of the group) involved publicly-traded companies without a control party, 25 (52.2%) involved a controlled or subsidiary company and nine (19.1%) involved a startup or close corporation. There were also 41 cases (8%) that concerned corporate opportunities, use of corporate assets, or competition. (Twelve of these cases also fall into the self-dealing transaction subset.) Eleven of these cases followed the classic fact pattern on which the director or officer snatches a deal from the company. But most cases in this category concerned insider trading (13 cases) or competition with the company (13 cases).

At the bottom line, we find that only 13 of 512 litigations concerned independent public-company self-dealing transactions outside of the M&A context, which is not a lot even assuming that an easier pleading standard regarding demand excusal would have resulted in a larger flow of complaints. The point is not that self-dealing transactions no longer matter or that their importance is only conceptual. Nor is the point that across-the-board independence solves all governance problems. The point is that, one way or the other, the corporate governance system has taken the self-dealing contract off the list of serious problems, at least where ownership and control are separate.

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<sup>211</sup> See, e.g., Matthew D. Cain, Jill E. Fisch, Steven Davidoff Solomon & Randall S. Thomas, *The Shifting Tides of Merger Litigation*, 73 VAND. L. REV. 603, 604 (2018) (“In recent years, over 96% of publicly announced mergers have attracted a shareholder lawsuit, with many mergers attracting suits in multiple jurisdictions.”).

This is not a surprising observation, given the general agreement that independent boards reduce agency costs.<sup>212</sup> Costs related to self-dealing transactions follow naturally as one of the agency costs thus reduced. This may or may not be a function of pervasive “independence” taken by itself; it could just as easily follow from changes in prevailing norms. Either way, the self-regulatory governance system has accomplished what Marsh and Clark thought only could be done with a federal law mandate.

## V. ERODED CASELAW RECONSIDERED

This Part draws on this Article’s regulatory and institutional account of today’s governance system to take a second look at the fourth phase of doctrinal erosion. Fiduciary law (and the erosion thereof) cannot be evaluated in isolation, for the law is only one of a number of factors that come to bear in the regulation and control of management conduct. Boardroom processes have evolved too, and in a good direction. It is no longer plausible to dismiss them wholesale with a reference to structural bias. If, as this Article contends, the corporate governance system is now worthy of the benefit of the doubt as regards its treatment of self-dealing transactions, then the phase four caselaw admits of a positive gloss. This Part applies the polish, taking a second look at recent developments in Delaware law. It starts with classic self-dealing transactions and goes on to cases on executive compensation and controlling shareholder duties, showing that changes in the governance environment have prompted a compensating rebalancing in the caselaw, as the Delaware courts fine tune their policing.

### A. Self-Dealing Transactions

The evolutionary erosion account makes a number of assumptions about boardroom processes, in particular the problem of structural bias. Let us revisit the topic. Professor Davis has demonstrated that structural bias is not a unitary behavioral condition. It is instead a collection

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<sup>212</sup> It does enhance the value of the firm if (1) it succeeds at agency cost reduction and (2) all other things are equal and agency cost reduction entails no countervailing costs. These are demanding assumptions. For the argument that there are significant countervailing costs, see Bratton & Sepe, *supra* note 181. Significantly, the results of empirical tests do not confirm systemic value enhancement. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 923-933 (1999); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1530 (2005). For further discussion, see Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 461-63 (2008).

of attributes.<sup>213</sup> The salience of some of these attributes has diminished with the rise of the independent board. CEOs no longer control the member nomination process, and, as we have seen, non-management directors no longer tend to have significant business relationships with the company. Collegiality, cooperation, and mutual sympathy doubtless are still important. But one wonders whether today those factors could work as much against self-dealing transactions as in their favor: today's model colleague would never dream of putting fellow directors in the awkward position traversing best practice to approve a suspect transaction.

We emerge with continued reasons for vigilance, ever ready to question the quality of a boardroom decision to approve an inside deal. But there has also been a change, for there is now an active possibility that such a decision is capable of passing inspection, despite residual traces of bias. Indeed, a process has emerged for application in just such a case—the independent special committee, backed by its own counsel and banker and the power to say no.

Return now to the historical erosion of the duty of loyalty. For Marsh and Clark, the move from prohibition to fairness scrutiny entailed a substantial value sacrifice, a sacrifice presumably materially magnified in the wake of the fourth phase's installation of business judgment as the standard of review in many cases. This Article's survey of the operation of today's governance system suggests the contrary. The self-regulating system now builds in enforcement of the same norm that motivated Marsh and Clark. It follows that the move away from as of right fairness scrutiny is defensible, if only as a judicial docket control adjustment.

Two additional developments counterbalance the historical trend toward a diminished fiduciary backstop. The first is the emergence of the Delaware judiciary as the leading articulator of corporate fiduciary law and its pursuit of a standards-based jurisprudence in which all management conduct is potentially vulnerable to scrutiny. Recent Delaware opinions routinely reference Berle's "twice testing" rubric, by way of saying that there are no completely safe harbors navigable by adherence to form.<sup>214</sup> Indeed, policing remains active even as barriers to

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<sup>213</sup> Kenneth B. Davis, Jr. *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L.REV. 1305, 1308-1309 (2005).

<sup>214</sup> See, e.g., *In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208, 1222 (Del. 2017); Brown v. Kellar, 2018 WL 6721263 at 7 n. 52 (Del. Ch.). See also Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 29 (2015)("[L] legal doctrine and case law precedent likely do less to tie the hands of the Delaware judiciary dealing with corporate oriented litigation than is the judicial norm. Given that corporate law cases brought in Delaware are often characterized by a high degree of fact specificity and given that many such cases will be governed by broadly cast fiduciary duty principles, Delaware judges often have as a practical matter substantial scope to be innovative.")

representative litigation continue to rise. Yes, the threshold question in today’s fiduciary litigation is the process inquiry into board independence rather than the substantive inquiry into transactional fairness. But the transactional facts still get put on the table. Once there for inspection, they can influence the application of the open-ended independence standard. The standard, in turn, is being applied with increasing strictness.<sup>215</sup>

The second development is the shift of power in the shareholders’ direction, a shift effected through the use (or threatened use) of the shareholder franchise. This takes us from the world that Berle described, where shareholders utterly depend on management good will and a backstop of legal protection, to a world where the management and shareholder interests bargain over the terms of the business plan and distributional outcomes. Seen against this background, Delaware’s signature movement to business judgment review of sell-side mergers based on fully informed, majority disinterested shareholder ratification<sup>216</sup> is more fairly characterized as adjustment than as erosion.

The adjustment even complements the Marsh-Clark policy analysis. Marsh and Clark wanted prohibition because ex post judicial fairness review fails to assure that inside deals replicate arm’s length bargains. Prohibition is now off the policy table. That being the case, searching process scrutiny emerges in place of substantive fairness as the logical focus of judicial effort, for it is better force the actors to get as close as possible to arm’s length ex ante than for reviewing judges to take inputs on fair pricing from hired experts ex post.

## **B. Executive Compensation**

None of the foregoing cleanses the system of management cupidity—after all, they now just take it out as compensation. Indeed, executive compensation has always been the weakest link in the chain of transactions subject to fiduciary scrutiny. This is intrinsic: managers must be paid, so this particular mode of self-dealing must be tolerated. The standard of review is business judgment, and the plaintiff has to show waste,<sup>217</sup> which is hard to do, given the judiciary’s historic

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<sup>215</sup> The classic, much criticized case *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 980 (Del. Ch. 2003), held that a close long-term friendship and independence were compatible. The recent case of *Sandys v. Pincus*, 152 A.2d 124, 129 (Del. 2016), finds that co-ownership of a private plane is incompatible with independence.

<sup>216</sup> See *supra* text accompanying notes 129-30.

<sup>217</sup> The more particular formulation is that the amount of compensation must bear a “reasonable relationship” to the value of the services performed. See CLARK, *supra* note 24, §6.01 at 192.

unwillingness to set compensation caps by reference to comparable companies.<sup>218</sup> The sixty compensation cases in this Article's Delaware database accordingly do not feature claims based on excessive amounts. They are instead grounded in failure to adhere to the terms of complex compensation schemes, in manipulation of the timing of equity grants, and in failure to make adequate disclosures in the annual proxy statement.<sup>219</sup>

Academic discussion of executive pay is very much in accord with the foregoing. It does not focus on fiduciary duty for, if there are structural problems, no one expects fiduciary law to solve them. Unsurprisingly, there is a standing diagnosis of structural infirmity. Under this diagnosis, management possesses and uses its excessive power to manipulate the system into compensating it excessively. The turn to equity compensation schemes does not ameliorate the problem, even as the schemes are touted for aligning management incentives in the shareholder interest. The schemes are seen as slackly designed, holding out rewards even when the manager beneficiaries have added no value.<sup>220</sup> But there is also a counter-diagnosis. This expands on the traditional justification for fiduciary law's light touch in the area:<sup>221</sup> market competition operates to contain management's manipulative instincts; disclosure mandates and shareholder ratification requirements work together to get details to the shareholders and the market.<sup>222</sup> With the waxing of shareholder power, the market control story becomes ever more credible,<sup>223</sup> even as incidents of excess certainly continue to pop up on the screen.

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<sup>218</sup> *Id.* at 193 (“If the average pay of top executives of apparently comparable companies is itself a tainted and suspect figure, with what is a given top executive’s pay to be compared, for the purpose of assessing fairness?”).

<sup>219</sup> *See, e.g.*, *Howland v. Kumar*, 2019 WL 2479738 (Del. Ch.)(successfully alleging timing manipulation and applying the intrinsic fairness standard of review); *In re Ebix, Inc. Stockholder Litigation*, 2018 WL 3545046 (Del. Ch.)(getting past motion to dismiss on a claim of misleading proxy disclosures); *Wilkinson v. A. Schulman, Inc.*, 2017 WL 5289553 (Del.Ch.)(seeking access to books and records to sustain a claim the directors issued a greater number of shares than contemplated by plan).

There has also been a recent tightening in the standard of review applied in the special case of the board's arrangements to compensate itself. When a plaintiff challenges such an arrangement, business judgment review only follows where stockholders approve a compensation plan that does not involve future director discretion in setting the amount of self-payment. *See In re Inv'rs Bancorp, Inc. S'holder Litig.*, 177 A.3d 1208 (Del. 2017); *Stein v. Blankfein*, 2019 WL 2323790 (Del.Ch.).

<sup>220</sup> *See* LUCIEN BEBCHUK, & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); GRAEF CRYSTAL, *IN SEARCH OF EXCESS* (1991).

<sup>221</sup> *See* Clark, *supra* note 22, § 6.1, at 192-93.

<sup>222</sup> *See, e.g.*, Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713 (1995).

<sup>223</sup> Martijn Cremers, Saura Masconale & Simone M. Sepe, *CEO Pay Redux*, 96 TEX. L.REV. 205 (2017)(providing empirical confirmation of the operation of market controls).



### C. Control and Influence

This Article's review of a database of proxy disclosures undercovers one topic of concern—self-dealing transactions between controlled companies and their controllers. Historically, control has triggered fairness scrutiny. But, as we have seen, a process door to business judgment review has opened here, too, based on approval by an empowered independent negotiating committee and disinterested shareholder ratification.<sup>224</sup> It is too early to tell whether the governance system's newfound strength is equal to this protective task, even as there is reason for optimism.

A countervailing adjustment in the caselaw should be highlighted. Given a classic self-dealing transaction in a company without a controlling shareholder, the standard of review follows from a determination as to whether a majority independent board gave its approval, with the Delaware courts showing increasing sensitivity to facts signalling that a director is subject to influence.<sup>225</sup> In contrast, a showing of shareholder control trumps the inquiry into board independence, for it amounts to a showing that the board is not independent. The court proceeds directly to fairness scrutiny (subject to the ministration of a corrective process based on an independent committee and shareholder ratification). An outright voting majority block tends to lead to a quick finding of shareholder control. A case where a shareholder has a large but less-than-majority block and a strong inside presence presents more problems for a plaintiff, but control can be shown on the facts.

Let us take a recent example, *In re Tesla Motors, Inc. Stockholder Litigation*.<sup>226</sup> Elon Musk, the company's chairman, CEO, and 22% blockholder, persuaded its board to make a large acquisition: a \$26 billion stock-for-stock merger at a hefty premium with a company called SolarCity.<sup>227</sup> Such a deal, even one into a different line of business, might not raise hackles. But in this case, Musk owned 22% of the target's stock.<sup>228</sup> Moreover, the target was in the midst of a desperate liquidity crisis.<sup>229</sup> There were, in other words, all the earmarks of a self-serving bailout of Musk's investment.

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<sup>224</sup> See *supra* notes 116-17 and accompanying text.

<sup>225</sup> See *supra* note 214 and accompanying text.

<sup>226</sup> 2018 WL 1560293 (Del. Ch.)

<sup>227</sup> *Id.* at 10-11.

<sup>228</sup> *Id.* at 5.

<sup>229</sup> *Id.* at 6.

Here was a self-dealing transaction holding out cognizable likelihood of abuse. As we have seen, the contemporary norm against self-dealing transactions carves out an exception for acquisitions, where they are tolerated subject to process protections—shareholder votes, proxy solicitations, and *Revlon* scrutiny. But that is on the sell-side. The Tesla challenge came on the buy-side, where the protective accoutrements tend not to come to bear. Indeed, in this case, no statute required shareholder ratification—transactional approval could have been complete in the Tesla boardroom. A Tesla shareholder vote was provided for nonetheless. Counsel apparently hoped that it would serve to import business judgment scrutiny in respect of a challenge in court.<sup>230</sup> And the merger, which had not been negotiated by an independent Tesla board committee, duly received Tesla’s shareholders’ approval.<sup>231</sup>

But the board did not succeed in securing business judgment review. The question on motion to dismiss was whether Musk should be deemed a controlling shareholder, a result leading to fairness as the standard of review. As noted, Musk’s ownership block fell well short of a majority.<sup>232</sup> Vice Chancellor Slight held Musk to be in control nonetheless, based on a searching look at the ties between Tesla and Musk and the approving directors (even directors deemed independent under the stock exchange rules), combined with a look at Musk’s dominance over Tesla’s business plan.<sup>233</sup>

In Delaware law today, influence makes for control in the right case, and the zone of influence as control has been expanding. A long-standing line recently was crossed when the Chancery Court held that possession of a contractual right to block a transaction implied control.<sup>234</sup> We see once again that policing remains vigorous, even though “as of right” fairness scrutiny has receded into history.

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<sup>230</sup> See *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) (holding that director approval of a transaction not subject to entire fairness review is entitled to pleading stage business judgment deference when the transaction is later approved by an uncoerced, fully informed majority vote of disinterested stockholders)

<sup>231</sup> 2018 WL 1560293, at 7-10.

<sup>232</sup> Because the merger had been ratified by the shareholders, a finding that Musk did not control meant business judgment scrutiny.

<sup>233</sup> 2018 WL 1560293, at 12-19. See also *Calesa Assocs., L.P. v. Am. Capital, Ltd.*, 2016 WL 770251, at 11 (Del. Ch.); *Thermopylae Capital P’rs, L.P. v. Simbol, Inc.*, 2016 WL 368170, at 14 (Del. Ch.); *N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 WL 4825888, at 11 (Del. Ch.).

<sup>234</sup> See *Basho Technologies Holdco B, LLC v. Georgetown Basho Investors, LLC*, 2018 WL 3326693, at 24-32 (Del. Ch.)

## **D. Commentary**

Barriers to judicial review of self-dealing transactions have risen steadily since Marsh wrote in 1966. The Delaware judiciary has played a prominent role in this change. The judges, in their ongoing back-and-forth with the bar and the academy, assure us that all is well. They in effect ask for our trust on the ground that every fact pattern is implicitly reviewed for fairness under their standards-based jurisprudence. An abusive transaction remains subject to attack, whether on the ground that board members were not independent, that a special committee process was infirm, or that a large shareholder effectively controlled the transaction's outcome. Meanwhile, barriers to judicial review serve as useful filters of meritless claims.

Only time can tell us whether this experiment in process-based fiduciary minimalism will be successful. Institutional factors matter more here than do particular doctrinal statements of rules and standards—the experiment will succeed only if the members of the Delaware bench are as good as their advocates say they are. Importantly, the bench gets the benefit of support from corporate counsel, for the move to standards and accompanying disavowal of safe harbors tips the scale to favor conservative over facilitative advice-giving. In an environment of growing uncertainty, the only thing that can be relied upon is clear cut independence completely free of contaminating noise on the screen.

This Article adds a point to the case for Delaware: the corporate governance system has evolved so as to shift the costs and benefits in the experiment's favor. Although the experiment holds out risks, particularly in respect of controlled companies, they are risks worth taking.

Meanwhile, neither the shareholders themselves nor their institutional intermediaries register any concern about a self-dealing problem. If there were such concern, one would expect to see a best practices initiative related thereto, as we have seen with staggered boards, plurality voting, and executive pay. Nothing stops an individual company from opting into a Marsh-type regime of prohibition in its charter. But no such initiatives have come to the fore.

## **CONCLUSION**

This Article reconsiders and rejects the evolutionary erosion account without directly refuting its case for prohibition. Recall that the case for prohibition turns on the invocation of the arm's length bargain as a normative standard. The case then asserts that unless the system pursuant to which a self-dealing transaction is approved (whether the approval comes in the boardroom, at

a shareholders' meeting, or in an ex post reviewing court) assures us that the transaction replicates the trade a sole owner would have made at arm's length, the shareholder interest inevitably suffers. Nothing in today's corporate governance system holds out such an assurance, however much the system's operation has improved across the past several decades. Boardroom approval processes now approach the quality of sole owner negotiation but do not replicate it.

But the shareholder interest suffers little even as barriers to judicial fairness review rise ever higher. This is because the governance system now plays an active protective role. It has made self-dealing transactions so inconvenient as change their cost-benefit posture within boardrooms. A norm of disfavor also operates, much alleviating the problem of structural bias. It follows that the classic self-dealing transactions no longer should be seen as inevitable, negative incidents of dispersed shareholding.

Areas of risk remain, particularly in controlled (or heavily influenced) companies, particularly in respect of mergers and acquisitions. Here, no prohibitive norm operates, for it is generally thought that the shareholders' overall interests are advanced if the board remains free to take a look at every deal that comes along, even one tainted by self-dealing. The governance system accordingly still relies on frequent reference over to judicial review. The case for referring these matters over to the discretion of the Delaware courts is robust.