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One Practitioner's Random Thoughts on Shareholders' Rights in the Modern Corporation

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Modern corporate law theory views shareholders as the "owners" of the corporation, which gives them a higher status than other corporate constituencies. This is the so-called "shareholder primacy" model, which holds that directors and managers of the corporation owe a fiduciary obligation to act for the benefit of the shareholders, and failure to give primacy to shareholder interests can give rise to a cause of action by the shareholders against the directors.[1] This view is a relatively recent phenomenon, and while it dominates corporate law in the United States, it is rare in most other countries.[2]

While the shareholder primacy model assumes that shareholders are the owners of the corporation, current corporate law does not give shareholders significant rights in the corporation. Rather, the dominant view of corporate law today is that the business and affairs of the corporation are managed by the company's board of directors.[3] As a practical matter, the board delegates and relies upon management to handle the day-to-day operations of the company, creating a further separation between the shareholders, the supposed owners of the company, and those running it. Shareholders have no right to direct or control the assets of the corporation and generally do not decide (or even have significant input into) such fundamental issues as whether a company should (i) be bought or sold, (ii) issue dividends, or how it should handle other financial issues, or (iii) what businesses it should pursue.[4] Such decisions are typically left to the board and management, who are constrained in their actions by the fiduciary obligations they owe to shareholders. However, shareholders do not have any claim against directors or managers who make poor business decisions so long as those decisions were made following reasonable investigation and in what the board and/or management perceived to be in the interests of the corporation.[5]

In fact, shareholders today have very limited rights with respect to the corporation. As discussed in more detail below, shareholders have the right to vote on certain issues, including the election of directors and certain fundamental economic issues such as a merger or liquidation. They also have the right to receive certain information from the company, and in rare circumstances to take certain actions on behalf of the company. Consistent with these limited rights, shareholders have very limited responsibilities for the company. Indeed, assuming a shareholder is not a majority shareholder or otherwise in control of the corporation, the shareholder owes no duties or responsibility to other shareholders of the company.

This chapter outlines the rights of the shareholder in the modern American corporation. The next section briefly reviews the historical role of the shareholder in the corporation as well as the philosophical debate that led to the current shareholder primacy model. The final section discusses the rights shareholders have today as well as the role of the board under the shareholder primacy model. The chapter concludes by reviewing some alternatives to the shareholder primacy model, including how other corporate constituencies are seeking to participate on corporate actions, as well as briefly reviewing how these issues are resolved in some other countries.

SHAREHOLDER RIGHTS IN THE CORPORATION: A HISTORICAL PERSPECTIVE

It has long been held that shareholders have very limited rights with respect to the affairs of the corporation.[6] One oft-cited opinion written nearly one hundred years ago described the role of the shareholder as follows:

> As a general rule, stockholders cannot act in relation to the ordinary business of a corporation. The body of stockholders have certain authority conferred by statute which must be exercised to enable the corporation to act in specific cases, but except for certain authority conferred by statute, which is mainly permissive or confirmatory . . . they have no express power given by statute. They are not by any statute in this state given general power of initiative in corporate affairs. Any action by them relating to the details of the corporate business is necessarily in the form of an assent, request, or recommendation. Recommendations by a body of stockholders can only be enforced through the board of directors, and indirectly by the authority of the stockholders to change the personnel of the directors at a meeting for the election of directors.[7]

Yet while courts have long recognized the limited authority of shareholders, the common law did not make directors directly answerable to shareholders.

Rather, the traditional view was that directors owe fiduciary duties to the corporation, not to individual shareholders.[8] This was because directors were acting directly on behalf of the corporation, whereas a special obligation to shareholders arose only when directors undertook special obligations or actions directly on behalf of shareholders.

The responsibility of directors to the corporation as a whole, as opposed to just the shareholders, was part of the general corporate law in most states. For example, the Massachusetts Supreme Judicial Court held that a shareholder did not have a right to bring a claim for insider trading against a director because there was no privity between directors and shareholders.[9] The court cited the "imposing weight of authority in other jurisdictions" in rejecting the proposition that directors are trustees toward individual shareholders.[10]

The view that directors generally do not owe fiduciary duties directly to shareholders began to change as a result of the 1929 stock market crash. The Securities Act of 1933 (Securities Act)[11] and the Securities Exchange Act of 1934 (the Exchange Act),[12] established an obligation on the corporation to provide full disclosure about its financial condition and affairs to shareholders. In addition, the creation of the Securities and Exchange Commission (SEC), with a mandate to protect investors, seemed to emphasize a new role for directors, where they would be held more accountable to shareholders.

The new federal legislation took place against the backdrop of one of the most significant debates in American corporate law history, that between Adolf Berle and E. Merrick Dodd in the *Harvard Law Review*.[13] This debate helped create the intellectual recognition that directors should be viewed as trustees with the responsibility to represent the interests of shareholders, and the corresponding view that shareholders may have a claim against directors acting in their own interests rather than on behalf of the corporation and its shareholders.[14]

While shareholder rights increased during this period, they were only one of many constituencies that had a claim on the corporation. Thus during the middle of the twentieth century it was recognized that directors owed duties to a wide variety of constituents, including the company's employees, customers, and even the general public. For example, in 1946 the chairman of Standard Oil described the goal of the modern corporation as maintaining "'an equitable and working balance among the claims of the various directly interested groups—stockholders, employees, customers and the public at large.'"[15] The notion that the corporation had a responsibility to nonshareholder constituencies was sufficiently settled by the mid-1950s that even Adolf Berle recognized that "[corporate] powers [are] held in trust for the entire community" and that therefore the debate between him and Dodd "has been settled (at least for the time being) squarely in favor of Professor Dodd's contention."[16]

This view began changing in the 1980s, with the increasing role of institutional investors and the rise of the takeover boom, which increasingly led to the view that American managers who focused on nonshareholder constituencies were too concerned about their own interests at the expense of shareholders.[17] In response to the managerial view of American capitalism, the "shareholder primacy" model took hold and became the dominant view of the role of the shareholder and the director. Under this theory, the primary purpose of the corporation is to maximize shareholder value, and thus the role of directors is to act on behalf of shareholders to increase the corporation's economic value.[18]

This view was articulated in a series of court decisions in the mid-1980s, the most notable of which are perhaps the Delaware Supreme Court's decisions in *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*,[19] and *Unocal Corp. v. Mesa Petroleum Co.*[20] In *Revlon*, the court held that when a sale of the corporation becomes "inevitable," the board's duty changes "from the preservation of [the corporation] as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."[21] Under these circumstances, the court held that it was inappropriate for the board to consider nonstockholder constituencies such as the interests of bondholders, employees, or others.[22] In *Unocal*, the court held that before giving the board the protection of the business judgment rule on a decision adopting a defensive measure designed to make a takeover of the company more difficult, the board must meet a two-part test: first, that the directors adopting the defensive measure have "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" prior to the adoption of the challenged defensive measure;[23] and second, that the challenged defensive measure was "reasonable in relation to the threat."[24] Meeting this standard requires "an evaluation of the importance of the corporate objective threatened; alternative methods for protecting that objective; impacts of the 'defensive' action, and other relevant factors."[25]

Revlon and *Unocal* were widely viewed as making clear that shareholders were the primary constituency within the corporation, and that a director's decision (at least in the corporate control context) must be based upon shareholder interests. In response to these decisions a number of states, including Indiana, New Jersey, North Carolina, Ohio, Pennsylvania, and Virginia, adopted so-called "nonshareholder constituency statutes," specifically rejecting the shareholder primacy philosophy and the corresponding additional burdens on directors requiring them to give primacy to shareholder interests. For example, the New Jersey statute states that if "the board of directors determines that any proposal or offer to acquire the corporation is not in the best interest of the corporation, it may reject such proposal or offer," and if the board "determines to reject any such proposal or offer, the board of directors shall have no obligation to facilitate, remove any barriers to, or refrain from impeding the proposal or offer."[26]

The rationale for these statutes was explained by the court in *Norfolk Southern Corp. v. Conrail Inc.*, a case challenging defensive measures adopted under Pennsylvania's statute.[27] The court noted that it "seems clear" that Pennsylvania's statute was enacted with Delaware decisions such as *Revlon* and *Unocal* "clearly in mind" and was adopted specifically to "exclude those." The court then described Delaware's focus upon stockholders rather than the corporation as a whole as "myopic" and expressly rejected the notion under Pennsylvania law that "the sole or at least the primary consideration by a board of directors in considering a competing offer by potential acquirers of the control of a corporation should be which competitor offers the best short-range price or profit for shareholders."[28]

Although this debate has continued, the majority position from both a legal and philosophical view is the shareholder primacy model. In part this reflects the sheer dominance of Delaware in corporate law, as more than half of all U.S. public companies and more than 60 percent of the *Fortune* 500 are incorporated in Delaware.[29] In addition, within the scholarly literature the debate has clearly been decided at present in favor of the shareholder primacy norm.[30]

SHAREHOLDER RIGHTS IN THE CORPORATION: THE MODERN VIEW

The general view today is that shareholders are the "owners" of the corporation, and that they "hire" (or vote) for directors and officers to manage the company's assets on their behalf. This is the so-called "principal-agent" model, where the primary issue in corporate law is to make directors and officers more accountable to the shareholders on whose behalf they act.[31] Yet a more accurate description of the relationship between the various interest groups in the corporation was given by Dean Robert Clark as follows:

> (1) corporate officers like the president and treasurer are agents of the corporation itself; (2) the board of directors is the ultimate decision-making body of the corporation (and in a sense is the group most appropriately identified with "the corporation"); (3) directors are not agents of the corporation but are *sui generis*; (4) neither officers nor directors are agents of the stockholders; but (5) both officers and directors are "fiduciaries" with respect to the corporation and its stockholders.[32]

Professor Clark's model is consistent with the reality of the property interest that shareholders actually have; specifically, this interest is solely in their shares, and not in the corporation's assets. Thus, shareholders have no direct access or claim on a corporation's assets, nor do they have the right to direct or control the disposition of those assets.[33] In addition, shareholders generally do not act like owners of the corporation. For example, their purchase of shares is typically not done to invest capital in the corporation (other than in the private equity or initial public offering contexts), and often the same institutional investors seeking the power and privileges of an owner either engage in active trading of their shares (and thus do not invest in the company for the long-term) or are passive investors holding their stock in index funds that they do not manage.[34]

Despite this, the shareholder primacy model remains in firm control today. Accordingly, this chapter discusses the direct rights of shareholders under current law as well as the current relationship between directors and shareholders, with a particular focus on the duties directors owe shareholders and how those duties are interpreted by the courts.

Shareholders' Voting Rights

Voting for Directors

The most fundamental right shareholders have is to vote on certain specific issues. Of these the most important is the right to vote on the election of directors, which occurs annually except where the company has a "classified" or "staggered" board in which the directors are divided (typically into three groups) such that each group of directors serves a staggered three-year term.[35] The staggered board has become a fairly common feature among public companies, undoubtedly at least in part because directors on a staggered board cannot be removed except for "cause" and because this feature requires two annual elections to change a majority of the board, even if a majority of the shareholders are opposed to the directors.[36]

The courts have been extraordinarily vigilant to protect a shareholder's right to vote, calling it the "ideological underpinning upon which the legitimacy of directorial power rests."[37] In *Blasius Industries, Inc. v. Atlas Corp.*, for example, the court held that when the board takes action "for the sole or primary purpose of thwarting a shareholder vote," the board must overcome the "heavy burden of demonstrating a compelling justification for such action."[38] Blasius owned 9 percent of Atlas's outstanding stock and initiated a consent solicitation to (i) expand the size of the Atlas board from seven to fifteen members and (ii) fill the eight vacancies with its own nominees. In response, the Atlas board adopted a bylaw amendment increasing the size of the board from seven to nine, and filling the two new vacancies. The effect of the bylaw amendment was that even if Atlas succeeded in its consent solicitation, it would still not control a majority of the board. The court found that in taking these actions the Atlas board was "not selfishly motivated simply to retain power" and that it acted in "a good faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization [being proposed by Blasius] that it feared, reasonably, would cause great injury to the [corporation]."[39]

Despite finding that the board acted in good faith and on an informed basis, the court still enjoined the board's adoption of the bylaw as "an unintended breach of the duty of loyalty." The court held that when the board acts for "the sole or primary purpose of thwarting a shareholder vote" it must overcome the "heavy burden of demonstrating a compelling justification for such action." The court found that the Blasius board had failed to meet this burden because "it had time (and understood that it had time) to inform the shareholders of its views on the merit of the proposal subject to stockholder vote."[40] The court ruled that:

> The only justification that can, in such a situation, be offered for the action taken is that the board knows better than do the shareholders what is in the corporation's best interest. While that premise is no doubt true for any number of matters, it is irrelevant (except insofar as the shareholders wish to be guided by the board's recommendation) when the question is who should comprise the board of directors. The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters.[41]

The court concluded by finding that the power to vote on directors had "transcending significance" within Delaware law, as it was what "legitimates" director power over "vast aggregations of property that they do not own."[42]

Voting in Other Contexts

The other primary areas where shareholders are given the direct right to impact corporate action are instances in which shareholder votes are a necessary step in authorizing a transaction such as a merger, a sale of substantially all of the corporation's assets, or dissolving the enterprise.[43] In the merger context a majority of shareholders of the company(ies) being merged generally must vote in favor of the transaction after the respective boards of each company have approved the proposed transaction.[44]

Yet it is important to note that shareholders in this situation have no substantive rights. For example, other than the right to vote, shareholders do not have the right to take any other action with respect to a merger. Thus if the merger occurs between two publicly traded companies, under Delaware law shareholders may have no right to appraisal (assuming that the consideration to be paid is publicly traded stock).[45] Further, while the documents sent to shareholders contain a tremendous amount of information concerning the merger, including the risks associated with the merger and the background and reasons for the board's recommendation, the merger documents do not contain any debate on the benefits of the proposed merger.[46]

As a result of this, and perhaps not surprisingly, an overwhelming majority of mergers are supported by shareholders. Indeed, one recent study found that of 209 acquiring-firm merger votes occurring between 1990 and 2000, all were approved by shareholders, with an approval rate based on voting rights (i.e., including abstentions and other nonvotes) of approximately 73 percent, and an approval rate based on nonabstention votes cast of nearly 98 percent.[47] Undoubtedly part of this result can be explained by the reality that a board that believes its proposed merger is not going to be approved by shareholders is likely to restructure or withdraw from the deal rather than have shareholders vote the deal down, but the numbers certainly indicate that the voting requirement, while significant (and perhaps most significant for its deterrent effect), has limits as a corporate governance mechanism.

Shareholder Direct Action outside the Voting Contest: The Litigation Alternative

Shareholder lawsuits have become a common way for shareholders to attempt to exercise their rights. Although there are multiple types of lawsuits shareholders can bring against companies, the three most typical are (i) suits under the federal securities laws, (ii) derivative actions, and (iii) class action lawsuits under state law challenging director conduct in mergers and acquisitions.[48] This chapter focuses upon cases under state rather than federal law, consistent with the focus of shareholder rights under state law.

Derivative suits are actions by a shareholder on behalf of the corporation to obtain redress for an injury to the corporation.[49] The potential benefits and risks inherent in derivative suits were explained by the Supreme Court more than a half century ago, in the landmark decision *Cohen v. Beneficial Industrial Loan Corp.*,[50] in which the court upheld a New Jersey statute requiring a derivative plaintiff to post a twenty-five-thousand-dollar bond as security for defendants' legal fees and costs in the event that the litigation was dismissed as being without merit:

> This [derivative] remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least the grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.
>
> Unfortunately, the remedy itself provided opportunity for abuse which was not neglected. Suits sometimes were brought not to redress wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of shareowners were compounded by the suing stockholder, who was mollified by payments from corporate assets.[51]

Following the *Cohen* decision as well as other contemporaneous criticisms of potential abuses with derivative actions,[52] a number of jurisdictions adopted various procedural steps in an attempt to ensure that a plaintiff seeking to act on behalf of the company not bring a frivolous claim. For example, and in addition to the bond requirement, these include making a demand upon the board of directors before proceeding with the litigation as well as being a "contemporaneous owner" of the company's stock throughout the litigation.[53] Whether because these cases are generally without merit (as many argue) or because the procedural and substantive burdens are so high (as plaintiff's counsel claim) or some combination of both, the reality is that derivative suits generally provide little direct benefits to shareholders, with the bulk of any funds paid going primarily to plaintiff's counsel.[54]

Class action lawsuits challenging a director's actions under state law, particularly in the merger and acquisition context, have also become more common in recent years.[55] Like derivative cases, these cases typically involve multiple, identical (or nearly identical) complaints filed within days of an announced acquisition, either in the company's state of incorporation or principal place of business (or both). The claims involved typically concern an alleged breach of the directors' duty of care (typically for not achieving a high enough price or getting a good enough deal) and/or loyalty (for obtaining benefits not equally available to other shareholders). Over 75 percent of the time the cases are filed by a small group of well-defined plaintiffs' law firms, and, unlike cases currently brought under the federal securities laws, these cases typically do not have institutional investors as plaintiffs.[56]

These cases have come under many of the same criticisms that other shareholder actions have faced. In particular, the high costs of defense, generally small returns to shareholders, and relatively high payments to plaintiffs' counsel (particularly in relation to the purported benefit being provided to shareholders) has led many to question whether these actions truly benefit shareholders.[57]

Guardian of the Corporate Bastion on Behalf of the Shareholders: The Board of Directors and the Business Judgment Rule

The Berle-Dodd debate in the 1930s assumed that the corporation was controlled by its managers, leading to the famous question "For whom are corporate managers trustees?"[58] In today's world this question has been settled. Corporations are, at least in theory, controlled by the board of (independent) directors, who have the obligation to run the company on behalf of shareholders.[59] This theory is consistent with both the American Law Institute's Corporate Governance Project[60] and the emphasis in the recently adopted Sarbanes-Oxley Act, which emphasizes the importance of independent directors and their role in monitoring the corporation and its management. The reality, however, is somewhat different. Thus, as Roberta Karmel has noted:

> The modern public corporation is a vast bureaucratic organization of great complexity. Although shareholders have the power to vote for directors and, in theory, the directors appoint the managers, both shareholders and directors are part time participants in the corporation's affairs. The corporate scandals of recent years have demonstrated that corporate managers, and in particular, CEOs, have great power and insufficient accountability. Without such power, they probably could not manage the modern corporation, which is based on a hierarchical structure.[61]

In managing the corporation, both the board and the officers are constrained by the fiduciary obligations they owe the company and its shareholders. These obligations include the fundamental duties of care and loyalty.[62] The duty of care requires that directors act on "an informed basis," which has been given a variety of interpretations, from a requirement that directors "exercise the care that an ordinarily prudent person would exercise under similar circumstances"[63] to a requirement that directors "inform[] themselves ... 'of all material information reasonably available to them.'"[64] In practice the standard of liability has become one of "gross negligence" such that a plaintiff challenging the board's actions under the duty of care standard must allege facts that show the board's conduct is grossly negligent to state a claim. As the Delaware Supreme Court held in *Smith v. Van Gorkum,* "The concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[65] In addition (and in response to this decision and its definition of "gross negligence") the Delaware legislature adopted a statutory provision to exculpate directors for a violation of the duty of care provided that the action was taken in good faith.[66] This has reinforced the notion that a director cannot be held liable under the duty of care unless the decision was grossly negligent.[67]

The duty of loyalty requires that a director act in good faith, put the interests of the company and its shareholders above his or her own interests, and not take advantage of his or her position as a director to harm the corporation or its stockholders.[68] As described by the Delaware Supreme Court in the seminal case of *Guth v. Loft:*[69]

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.... A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interest of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation.... [T]he rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

A shareholder bringing an action alleging that a director (or board) breached either of these duties must overcome the presumptions of the business judgment rule. The business judgment rule is both a rule of procedure and a substantive rule of law.[70] Procedurally, the rule places the initial burden on the plaintiff to allege facts in the complaint sufficient to show that a director (or board) violated one of these two duties. Thus at the pleading stage the plaintiff must allege in detail how a director acted with gross negligence (to state a claim under the duty of care) or acted in self-interest to the detriment of the corporation (to show a violation of the duty of loyalty).[71] Failing to allege such facts with adequate specificity will result in dismissal of the complaint.[72]

Substantively, if the business judgment standard of review is held to apply to a board's decision, the decision will not face substantive review (or be "second-guessed") by the court. Thus, under this rule a director's decision will not be subject to challenge, review, or liability, even if erroneous, so long as the duties of care and loyalty are satisfied.[73] As the Delaware Supreme Court summarized these protections, "[i]f a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule operates to provide substantive protection for the directors and the decisions that they have made."[74]

It is important to note that there are situations where the substantive or procedural protections of the business judgment rule do not apply. For example, if it is shown that a director of a company stands on both sides of a particular transaction, then the director (and the board) may be required to show that the transaction was "entirely fair" to the corporation and its shareholders, meaning that both the price and process employed in the transaction were fair to shareholders.[75] In addition, under the so-called *Unocal* standard discussed earlier, Delaware generally shifts the burden of proof whenever a board adopts a defensive measure in response to a threat to the corporation, its policies, or stockholders. Under these circumstances, before a board can receive the protections of the business judgment rule, directors must satisfy a two-part test. This test requires the board to show (i) after reasonable investigation, that a "danger to corporate policy and effectiveness existed"; and, once this finding is made, the board still has the burden of proof to demonstrate (ii) that the specific measure adopted in response was "reasonable in relation to the threat posed."[76]

Yet despite these modifications, the bedrock principles supporting the business judgment rule continue to ensure that directors remain the primary decision-makers in the corporation. When combined with the shareholder primacy theory dominating corporate law today, this means that a board decision that the directors reasonably believed was in the interests of the shareholders and taken in good faith will not be subject to substantive review by a court.

SOME FINAL THOUGHTS ON THE RIGHTS OF SHAREHOLDERS: ARE WE AT THE END OF CORPORATE LAW AND SHOULD WE BE HAPPY?

The primacy of Delaware law in American corporate law jurisprudence, when combined with its emphasis on the business judgment rule and the rights of shareholders, means that the shareholder primacy model dominates today's legal landscape. Yet this domination is rather remarkable, given that a large number of states and many countries have statutory regimes allowing or mandating that directors consider the effects of their actions on other corporate constituencies, including employees, communities, and others. Further, as described above, these statutes are consistent with what, until at least the middle of the twentieth century, was the general legal landscape in the United States.

There are a number of powerful critics of this shareholder primacy model. For example, one school of thought has argued at length for a "stakeholder" model of governance. This model argues that the shareholder primacy model gives shareholders too much of a claim to the rights and benefits of the corporation and argues that some of these privileges and rights should go to other stakeholders in the corporation, such as employees and others.[77] This is consistent with many state statutes, which gained favor in response to the takeover boom in the late 1980s and remain part of the corporate landscape in many states.

A second model focuses on director primacy, looking to the board to act as a mediator between the various corporate constituencies, and explains why the traditional notions of shareholders as owners and the shareholder primacy models are not accurate.[78] Under this model, directors are in the best position to recognize the role of employees, creditors, executives, and even the community in the success of the firm, and balance these competing interests. As one of the principal proponents of this theory describes it, the "board of directors is not an agent of the shareholders; rather, the board is the embodiment of the corporate principal, serving as the nexus of the various contracts making up the corporation."[79]

A third model, which at least historically was common to a number of European jurisdictions, views the corporation as a public entity, which has its first responsibility to the community in which it exists. This model emphasizes the ethical responsibility of the corporation to its community as well as to the stockholders and is grown out of the historical basis view that the corporation was an enterprise of the state.[80]

As a practitioner in today's environment, it is easy to dismiss these alternative models that seem so far from the shareholder primacy norm. Further, there is an argument that in today's environment of corporate scandals, the need for shareholders to act like owners is greater than ever, as failure to establish stronger standards by which shareholders can exercise ownership rights gives management greater ability to act in its own interests and contrary to those of not just shareholders but other corporate constituencies. Yet in the end what is most striking about any of these models is how little direct authority shareholders have in today's corporation. Rather, what all the models discussed above have in common is that each looks to some force other than the shareholders—the presumptive owners of the corporation—to act as the controlling influence on the corporation. Whether this control resides in the hands of managers, directors, or even the state, what is clear is that the separation of stock ownership from control of the corporation, which was the issue raised in the great Berle-Dodd debates, is as great as at any time in history.

NOTES

The author would like to thank Lisa Schwartz Kirby and Leila Ahlstrom Guerrero for their assistance with this article. However, the author is solely responsible for any errors, and the views expressed herein are solely his and not those of his firm.

1. See generally Stephen M. Bainbridge (2003), Director primacy: The means and ends of corporate governance, *N.W. U. L. Rev., 97,* 547 (discussing the model and its impact).

2. There are also a number of states in which the director primacy model is explicitly rejected. See section II, infra. Professor Constance Bagley discusses this issue from a somewhat different view in her chapter in this book. See Constance Bagley, Shareholder primacy is a choice, not a legal mandate.

3. Del. Code Ann. tit. 8, sec. 141(a).

4. See Roberta S. Karmel (2004, May), *Should a duty to the corporation be imposed on institutional shareholders?* Brooklyn Law School, Public Law Research Paper No. 11, available at http://ssrn.com/abstract=546642

5. This is the so-called business judgment rule. See generally notes 70–76 and corresponding text, infra.

6. There are three general types of corporations in the United States today. The first, and the type that is the focus of this chapter, is the publicly held corporation, which is typically owned by a large number of shareholders. The second is the privately held corporation, which may have any number of shareholders but whose shares are not sold to the public. Finally, there is the close corporation, generally defined as a corporation owned by a limited number of shareholders, most of whom are actively involved in the management of the corporation. Most public corporations in the United States are incorporated in Delaware, and thus generally this chapter looks to Delaware law when discussing the state laws governing corporations.

7. *Continental Sec. Co. v. Belmont*, 99 N.E. 138, 141 (N.Y. 1912).

8. See Karmel, supra p. 6 at n.15 (citing *Percival v. Wright*, 2 Ch. 421 (1902)).

9. *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933). See generally, Karmel, supra.

10. *Goodwin*, 186 N.E. at 660.

11. 15 U.S.C. sec. 77a et seq.

12. 15 U.S.C. sec. 78a et seq.

13. See A. A. Berle Jr. (1931), Corporate powers as powers in trust, *Harv. L. Rev., 44,* 1049; E. Merrick Dodd Jr. (1932), For whom are corporate managers trustees? *Harv. L. Rev., 45,* 1145. See also Adolf A. Berle Jr. and Gardiner C. Means (1932), *The modern corporation and private property*.

14. Some commentators have argued that the Michigan Supreme Court's decision in *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) was the earliest and strongest opinion supporting the shareholder primacy view. However, as a number of scholars have pointed out, Dodge was a highly unusual case, and the real issues in the case may not have been between shareholders and stakeholders but rather between competing groups of shareholders. See, for example, Jesse H. Choper et al. (1989), *Cases and materials on corporation law* (3d ed.,) 994–95; Margaret Blair and Lynn Stout (1999), A team production theory of corporate law, *Va. L. Rev., 85,* 247, 301–3.

15. See Eugene V. Rostow, To whom and for what ends is corporate management responsible, in *The corporation in modern society*, 46, 60 (Edward S. Mason, ed.). See also Blair and Stout, A team production theory of corporate law, supra at 286.

16. Adolf A. Berle Jr. (1954), *The twentieth-century capitalist revolution,* 169.

17. See, for example, Stephen M. Bainbridge (2003), Director primacy: The means and ends of corporate governance, *Nw. U.L. Rev., 97,* 547; Bernard Black and Reinier Kraackman (1996), A self-enforcing model of corporate law, *Harv. L. Rev., 109,* 1911.

18. See, for example, Black and Kraackman, supra *Harv. L. Rev., 109,* at 1921 (describing the "maximizing [of] the company's value to investors" as the "principal function of corporate law").

19. 506 A.2d 173 (Del. 1986).

20. 493 A.2d 946 (Del. 1985).

21. Revlon, 506 A.2d at 182.

22. For a thorough discussion of *Revlon* and its progeny as well as how the case has been applied over the years, see Dennis J. Block, Nancy E. Barton, and Stephen A. Radin, *The business judgment rule,* (5th ed)., 694–770.

23. Unocal, supra 493 A.2d at 955.

24. Ibid., 955.

25. *Paramount Communications Inc. v. Time Inc.*, 571 A. 2d 1140, 1154 (Del. 1990). See generally Block et al., *The business judgment rule,* supra (discussing the case law interpreting *Revlon* and *Unocal*).

26. N.J. Bus. Corp. Act sec. 14A:6-1(3), cited in Block, supra at 688–689.

27. No. 96-7167, 1996 WL, 33649421 (E.D. Pa. November 19, 1996), *aff'd* mem., 111 F.3d 127 (3d Cir. 1997).

28. Ibid., Tr. at 646–655.

29. In contrast, the state incorporating the second-largest number of *Fortune* 500 companies (New York) has approximately 5 percent. See Kent Greenfield (2004), Democracy and the dominance of Delaware in corporate law, *Law and Contemporary Problems, 67,* 101, 102.

30. See generally Blair and Stout, Team production theory, supra at 324–327 (discussing why the shareholder primacy model gained general acceptance within the academic community during this period); Karmel, supra note 4 (same).

31. The literature using the principal-agent approach has been described as "to voluminous too cite in its entirety." Blair and Stout, A team production, supra at 248, n.1. The leading articles include Victor Brudney (1985), Corporate governance, agency costs, and the rhetoric of contract, *Colum. L. Rev., 85,* 1401, Frank J. Easterbrook and Daniel R. Fischel (1991), *The economic structure of corporate law,* and Frank J. Easterbrook and Daniel R. Fischel, The proper role of a target's management in responding to a tender offer, *Harv. L. Rev.*, 94, 1161.

32. Robert C. Clark (1985), *Agency costs versus fiduciary duties, in principals and agents: The structure of business* (John W. Pratt and Richard J. Zechhauser eds.,), 56.

33. See generally Stephen Bainbridge (2002), The board of directors as nexus of contracts, *Iowa L. Rev., 88,* 1.

34. See generally Karmel, supra at 2.

35. Del. Code Ann. tit. 8, sec. 141(d).

36. See Lucian A. Bebchuk, John C. Coates IV, and Guhan Subramanian (2002), The powerful antitakeover force of staggered boards: Further findings and a reply to symposium participants, *Stan. L. Rev., 55,* 885. Lucian Bebchuk, Alma Cohen, and Allen Farrell, *Discussion paper no. 491* (09/2004, revised 11/2004), available at http://papers.ssrn.com/abstract_id=593423

37. *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

38. Ibid., 661–662. The so-called "*Blasius* doctrine" was subsequently adopted and affirmed by the Delaware Supreme Court. See, for example, *Stroud v. Grace*, 606 A.2d 75 (Del. 1992).

39. Blasius, 564 A.2d at 656–658.

40. Ibid., 661–663.

41. Ibid., 663.

42. Ibid., 659–662.

43. See generally *Williams v. Geier*, 671 A.2d 1368, 1379 (Del. 1996); Del. Code Ann. tit. 8, secs. 271(a), 251(c).

44. See for example, Del. Code Ann. tit. 8, sec. 251.

45. See for example, Del. Code. Ann. tit. 8, sec. 262. See generally Peter V. Letsou (1998), The role of appraisal in corporate law, *B.C. L. Rev., 39*, 1121 (discussing use and theory of appraisal remedy).

46. See generally James A. Fanto (2000, May 22), *Breaking the merger momentum: Reforming corporate law governing mega-mergers.*

47. See Timothy R. Burch, Angela G. Morgan, and Jack G. Wolf (2004, May), *Is acquiring-firm shareholder approval in stock-for-stock mergers perfunctory?*

48. There are numerous articles and studies concerning shareholder lawsuits under the federal securities laws and derivative suits. For a summary of this literature as well as a discussion about how "acquisition-oriented suits are now the dominant form of corporate litigation," see Robert B. Thompson and Randall S. Thomas, *The new look of shareholder litigation: Acquisition-oriented class actions*, Vanderbilt University Law School, Law and Economics, Working Paper No. 03-04, available at http://ssrn.com/abstract_id=401580

49. See generally D. Block et al., *The business judgment rule*, supra at 1379–1385.

50. 337 U.S. 541 (1949).

51. Ibid., 548. For a historical discussion of derivative suits, see Franklin S. Wood (1944), *Survey and report regarding stockholders' derivative suits*; for a more recent analysis, including a discussion of the Wood report and its impact, see Thompson and Thomas, *The new look of shareholder litigation*, supra.

52. See, for example, Wood, supra.

53. The literature on the procedural requirements for bringing a derivative action is voluminous, and the standards continue to develop and change. For an overview and discussion of these requirements see Block et al., supra note 22. For a recent discussion of the changing nature of the derivative action, and in particular what constitutes a derivative claim as opposed to a direct claim, see *Tooley v. Donaldson, Lufkin and Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004) (Delaware Supreme Court redefining the distinction between direct and derivative claims).

54. Again, the studies on the benefits and costs of derivative suits are numerous and voluminous. See generally Thompson and Thomas, *The new look of shareholder litigation* supra (discussing various studies).

55. See Thompson and Thomas, supra at 5–7 (finding that such cases "dominate all other forms of state court shareholder litigation" and that in Delaware alone during the two-year period 1999–2000 such cases "equaled about half the total number of federal securities fraud class actions filed in *all* federal district courts during that same two-year period."

56. Ibid., 7–8.

57. But see ibid., supra at 5. (Arguing that "good policy must balance the positive management agency cost reducing effects of these acquisition-oriented shareholder suits against their litigation agency costs" and that these suits may have "positive management agency cost reducing effects that may offset the litigation agency costs that accompany them.")

58. See E. Merrick Dodd Jr. (1932), For whom are corporate managers trustees? *Harv. L. Rev., 45,* 1145; A. A. Berle Jr. (1932), For whom corporate managers are trustees: A note, *Harv. L. Rev., 45,* 1365.

59. Stephen M. Bainbridge (2003), Director primacy: The means and ends of corporate governance, *N.W. U.L. Rev., 97,* 547.

60. American Law Institute (1994), *Principles of corporate governance: Analysis and recommendations.*

61. Karmel, 29–30.

62. For a detailed and thorough discussion of these duties and the cases discussing them, see Block et al., supra note 22.

63. See, for example, *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (holding that in managing the affairs of the corporation directors are "bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances"); *Norlin Corp. v Rooney*, Pace, Inc. 744 F.2d 255, 264 (same).

64. See, for example, *Smith v. Van Gorkum*, 488 A.2d 858, 872–873 (Del. 1985) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984)).

65. *Smith v. Van Gorkum.*

66. See Del. G. Corp. Law sec. 102(b)(7). Under section 102(b)(7) there are four enumerated exclusions to the ability of a corporation to eliminate (or limit) director liability: (i) a breach of the duty of loyalty; (ii) acts or omissions not taken in good faith or involving intentional misconduct or knowing violations of law; (iii) unlawful payments of dividends; or (iv) self-interested transactions. Interestingly, a number of recent Delaware cases have raised questions concerning the scope of a so-called "duty of good faith," which may give rise to another type of cause of action. See generally, Sean J. Griffith (2004, December 17), *The good faith thaumatrope: A model of rhetoric in corporate law jurisprudence* (draft).

67. However, it should be noted that the standard of liability and judicial review is, of course, different from a standard of care. Thus the change in liability standards does not change the expected care with which directors are to act. See generally, William T. Allen, Jack B. Jacobs, and Leo E. Strine Jr. (2001), Function over form: A reassessment of standards of review in Delaware corporation law, *Bus. Law., 56,* 1287.

68. Block et al., supra note 22.

69. 5 A.2d 503, 510 (Del. 1939).

70. See *Aronson v. Lewis*, 473 A.2d at 812.

71. Ibid.; see also *Beam v. Stewart*, 845 A.2d 1040, 1048–49 (Del. 2004); *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993).

72. See, for example, *Orman v. Cullman*, 794 A.2d 5, 15 (Del. Ch. 2002); Block et al., supra at 19–28.

73. Aronson, 473 A.2d at 812; Van Gorkum, 488 A.2d at 872–73; Block et al., supra at 19–28.

74. *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001).

75. See *Weinberger v. UOP*, Inc., 457 A.2d 701, 710 (Del. 1983).

76. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). The court applies this stricter scrutiny to director conduct because, in part, of "the omnipresent specter that a board may be acting primarily in its own interests" rather than for shareholder interests. Idem. The cases discussing these standards, and the factual situations that determine what a "threat" is and whether a response is "reasonable" have been the subject of lengthy (and ongoing) debate. The most thorough summary is probably in Block et al., supra at 631–659.

77. See, for example, Marleen A. O'Conner (1993), The human capital era: Reconceptualizing corporate law to facilitate labor-management cooperation, *Cornell L. Rev.*, *78*, 899; John C. Coffee Jr. (1990), Unstable coalitions: Corporate governance as a multi-player game, *Geo. L.J.*, *78*, 1495.

78. See, for example, Blair and Stout, A team production theory of corporate law, supra; Stephen Bainbridge (2003, July 28), *The business judgment rule as absention doctrine*, UCLA Law and Economics research paper.

79. Bainbridge, supra at 4.

80. See generally, Dirk Zetzsche (2004, September 23), *Explicit and implicit system of corporate control: A convergence theory of shareholder rights*.