How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors

*By E. Norman Veasey and Christine T. Di Guglielmo**

As business trends change and capital markets evolve, directors may face factual situations that raise new questions about the contours of directors' fiduciary duties. One increasingly common situation that presents tensions for a growing number of directors is the allegiances by individuals elected to the board by, and who may seemingly "represent," particular constituencies of the public corporation. Such "constituency directors" or "representative directors" may include, for example, directors designated by creditors, venture capitalists, labor unions, controlling or other substantial stockholders, or preferred stockholders; directors elected by a particular class of stockholders; or directors placed on the board by or at the behest of other constituencies.

We raise several questions. When a particular constituency causes one or more directors to be elected to the board, to whom or to what is that director loyal or beholden? The corporation? All the stockholders? If "yes" as to the corporation and all the stockholders, may the director give some "priority" to the views of the constituency that caused him or her to be placed on the board? Since the board must act collectively and the majority might not favor the outcome desired by the particular constituency, are these questions largely academic?

In this Article, we suggest that the existing standards of liability for breach of fiduciary duty should not change in order to account for changing circumstances. The existing standards of conduct and liability incorporate the necessary flexibility to balance the potentially competing duties of constituency directors with protection of the interests of various corporate constituencies. And if the fiduciary duty standards in corporation law are not sufficiently flexible to accommodate particular circumstances, constituents may wish to invest in an alternative entity (such as a limited liability company) governed by other law that will accommodate their needs. Or perhaps the investor may be able to effect a legally authorized change in the certificate of incorporation of the corporation to permit it to be governed more to the investor's liking.

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Introduction

Imagine BioMed—a public biotechnology company incorporated in Delaware with a commercially promising product, MiraMed, nearing the end of the research and development pipeline but with no revenue-generating products yet on the market. The company is bleeding cash in order to continue its R&D efforts. The common stockholders are holding onto their stock in the desperate hope that MiraMed will soon reach the market, raining cash on the company and thereby generating substantial value for the common stockholders. The circumstances are dire. Without a large infusion of cash, BioMed will be forced to cease operations within a month, losing its opportunity to realize the large potential upside of MiraMed.

But BioMed also has a class of preferred stock with a liquidation preference. The preferred stock is held by a small group of institutional investors. Those preferred stockholders have the right to elect two directors to BioMed's five-member board. Angela Adams and Bob Breyer currently serve as the two directors elected by the preferred stockholders. Two of the five directors are outside, "independent" directors. The fifth is the chairman and chief executive officer.

The BioMed board has engaged in a thorough and confidential search of financing and strategic options and has identified only two viable alternatives. The first is a financing transaction: BioMed can borrow $5,000,000 from PipeDream Inc. on a secured basis in exchange for a note and warrants exercisable into a sufficient number of authorized but unissued shares of common stock to constitute one-half of BioMed's outstanding stock. The PipeDream loan would enable BioMed to continue operations for six months. The second alternative is liquidation, a move that would distribute most or all of BioMed's assets to the preferred stockholders.

The CEO and the general counsel have advised the board that: (a) implementation of either the liquidation alternative or the PipeDream loan would require approval by four out of BioMed's five directors under supermajority provisions contained in BioMed's certificate of incorporation; (b) the board must make an objective judgment as to the best interests of the corporation and all its stockholders; and (c) no director may share or leak any information outside the boardroom.

Adams and Breyer believe that the preferred stockholders would prefer to cut their losses and liquidate BioMed's assets, rather than pursuing the risky but potentially lucrative strategy of securing financing that would enable a last-ditch effort to get MiraMed through the pipeline and to the market. By contrast, the common stockholders would receive nothing in liquidation and would presumably prefer the PipeDream transaction.

The board must decide whether to liquidate or to accept the PipeDream loan. Will Adams and Breyer breach their fiduciary duties if they vote in favor of liquidation, as they believe the preferred stockholders—their constituency—would like them to do? Will they breach their fiduciary duties if they consult with the preferred stockholders, particularly Paul Parsimony, the preferred stockholder who owns 70 percent of the voting power of that class?

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Delaware courts have been clear that fiduciary duties—or, more precisely, the standards by which directors' liability for breaches of fiduciary duty is judged—do

not change over time.[1] What may change over time is the circumstantial and contextual backdrop against which the duties of the board of directors and those of individual directors are viewed.[2] As business trends change and capital markets evolve, directors may face factual situations that raise new questions about the contours of directors' fiduciary duties.[3]

An increasingly common factual scenario that raises such questions is that involving the responsibilities of individuals who may be elected to the board by, and thus may seemingly "represent," particular constituencies of the corporation. They may be called "constituency directors" or "representative directors." Examples include directors designated by creditors, venture capitalists, labor unions, controlling or other substantial stockholders, or preferred stockholders; directors elected by a particular class of stockholders or by a minority interest under a cumulative voting scheme; or directors representing other constituencies.[4]

Increasingly complex capital structures, including issuance of preferred stock or classes of stock, the more prominent role of private equity, and other factors may involve contracts or corporate governance provisions that have the potential to create loyalty tensions. When a particular constituency other than the common stockholders (or the stockholder body as a whole) places one or more directors on the board, to whom or to what is that director loyal or beholden?

While new situations may raise questions about liability for breach of fiduciary duty, should the answers change or should they remain immutable? In this Article we suggest that the standards of liability for breach of fiduciary duty should not change in order to account for new or increasingly common circumstances implicating fiduciary duties. The standards of conduct and liability already incorporate the necessary flexibility to balance the potentially competing duties of

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1. *See, e.g., In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005) ("Unlike ideals of corporate governance, a fiduciary's duties do not change over time."), *aff'd*, 906 A.2d 27 (Del. 2006); *cf.* E. Norman Veasey with Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1405 (2005) (distinguishing standards of conduct from standards of review and stating that "[t]he expectations for director conduct evolve over time as business mores evolve, with courts applying the evolving expectations in a common law process in deciding the proper standard of review to apply in specific circumstances" and that "[t]here has been no change in Delaware law of the time-honored business judgment rule, which remains alive and well").

2. *See, e.g., Disney*, 907 A.2d at 697–98 ("How we understand those duties may evolve and become refined, but the duties themselves have not changed.... Fiduciaries who act faithfully and honestly on behalf of those whose interests they represent are indeed granted wide latitude in their efforts to maximize shareholders' investment. Times may change, but fiduciary duties do not.").

3. *See* Veasey & Di Guglielmo, *supra* note 1, at 1436–39 (discussing the "evolving expectations" of directors); *see also Disney*, 907 A.2d at 760 n.487 (hinting that post-*Disney* there might be a higher bar for good faith as a result of the *Disney* decision itself).

4. *See, e.g.*, Cyril Moscow, *The Representative Director Problem*, INSIGHTS, June 2002, at 6 (noting many of these categories of representative directors); *cf. also* Terence Woolf, Note, *The Venture Capitalist's Corporate Opportunity Problem*, 2001 COLUM. BUS. L. REV. 473, 473 (suggesting that application of the traditional duty of loyalty rubric and corporate opportunity test in the venture capital context "has the potential to harm capital formation and business development" because they are based on an "anachronistic and ineffectual" "notion that directors and officers owe their undivided loyalty to a single company and its shareholders").

constituency directors with protection of the interests of the corporate entity or other corporate constituencies under most circumstances.

We focus on constituency director issues in the context of Delaware corporations that have public, common stockholders unrelated to the constituency sponsor of a particular director. We do not include in our working definition of "constituency director" a director elected by the public, common stockholders of a non-controlled company, even if she is elected in a proxy contest. Election by the stockholders as a whole may (or may not) alter the analysis of constituency director issues. Similarly, we do not address whether an initially board-appointed constituency director's later reelection as part of the management slate alters her status as a constituency director.

Whether and how a constituency director can carry out his fiduciary duties is context-dependent. Many—probably most—board functions and decisions may not present a conflict issue. In a healthy, well-functioning company, for day-to-day business issues (i.e., "enterprise issues" as distinct from "ownership issues"),[5] the interests of all constituencies may be generally aligned. That is, all constituencies generally should be interested in the long-term value of the company.[6] Where that is the case, the corporate interest serves as a proxy for the interests of the stockholders.[7] Indeed, the Delaware Supreme Court sometimes articulates directors' fiduciary duties as owed to "the corporation" and sometimes articulates the duties as owed to "the corporation and its shareholders."[8]

Certain sponsors may sometimes have interests other than maximizing long-term financial returns on investment, even under normal, day-to-day circumstances. For example, an investor may be interested in seeing a company make environmentally favorable business decisions, even if doing so reduces financial returns. But such an investor could make a reasoned argument that operating a business in an environmentally sustainable way also makes good business sense and therefore

5. *See* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 Bus. Law. 1, 5–6 (1985) (comparing "enterprise issues" and "ownership claim issues").

6. To be sure, there will be some investors, including some hedge funds, whose time horizons are short, and whose investment strategy is to maximize their return quickly.

7. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (suggesting that duty is owed primarily to the stockholders, but the corporation is a proxy for the stockholders in most circumstances); *cf. also* Int'l Bhd. of Teamsters Gen. Fund v. Fleming Cos., Inc., No. CIV-96-1650-A, 1997 U.S. Dist. LEXIS 2979, at *2 (W.D. Okla. Feb. 19, 1997) (stating that a corporation's stockholders "are, in fact, the corporation").

8. *Compare, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("It is well settled that directors owe fiduciary duties to the corporation."); Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("'[A] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.'" (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003))); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that the business judgment rule is a presumption that "in making a business decision the directors of a corporation acted . . . in the best interests of the company"), *with Gheewalla*, 930 A.2d at 99 ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders."); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders . . . ."); Revlon, Inc. v. MacAndres & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) ("[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.").

increases long-term financial value.[9] Thus, the existence of such interests does not necessarily undermine the general premise that stockholders usually are interested in the long-term value of the company. But recognizing that opinions may differ regarding the impact of any business decision, including social or environmental decisions, on long-term financial value—the very rationale underlying the business judgment rule[10]—this Article focuses on financial interests in analyzing how the interests of various corporate constituencies may differ.

Where the interests of various constituencies do diverge—that is, where the corporation's interests do not serve as well as a proxy for the interests of the stockholding body as a whole, as in some "end game" or "bet the company" scenarios—a constituency director may need to evaluate whether that divergence may subject the director to a conflict. And if so, the director will need to consider what the director's course of action should be to "do the right thing"[11] as well as to avoid liability. In undertaking that evaluation, the director must first consider to whom he owes fiduciary duties. That question underlies the potential tension that constituency directors face in fulfilling both their fiduciary duties and their obligations to their constituencies.

II. To Whom Do Directors Owe Their Fiduciary Duties?

"It is well established that the directors owe their fiduciary obligation to the corporation and its shareholders."[12] But what does this mean when the interests of "the corporation" diverge from the interests of the stockholders, when the

9. *See, e.g.*, ALI Principles of Corporate Governance: Analysis and Recommendations § 2.01 cmt. f (1994) ("Activity that entails a short-run cost to achieve an appropriately greater long-run profit is therefore not a departure from the economic objective. An orientation toward lawful, ethical, and public-spirited activity will normally fall within this description."); ABA Section of Bus. Law, Comm. on Corporate Laws, Corporate Director's Guidebook 31 (5th ed. 2007), *in* 62 Bus. Law. 1482 (2007) ("Compliance with environmental standards... is particularly important, because violations can in many cases have a material financial effect on the corporation.... Global warming and being a 'green company' are other examples of environmental issues that can affect business reputation, culture, and morale."); Ira M. Millstein, Holly J. Gregory & Rebecca C. Grapsas, Rethinking Board and Shareholder Engagement in 2008, Weil Gotshal & Manges Corporate Governance Advisory Memorandum (Jan. 2008), http://www.weil.com/news/pubdetail.aspx?pub=6382 ("Shareholders have legitimate interests in information about corporate policies and practices with respect to social and environmental issues such as climate change, sustainability, labor relations and political contributions. These issues... bear on the company's reputation as a good corporate citizen and consequently, the perceived integrity of management and the board."); *see also* Kelly v. Bell, 266 A.2d 878, 879 (Del. 1970) (noting that when directors decided to cause corporation to make voluntary "tax" payments they "believed with good reason that [the corporation] would derive substantial benefit therefrom—a belief which has apparently proven justified").

10. The business judgment rule "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 interests of the company." *Aronson*, 473 A.2d at 812. Where the business judgment rule presumption applies, a board's decision "will be upheld unless it cannot be 'attributed to any rational business purpose.'" *Disney*, 906 A.2d at 74.

11. *See generally* Veasey & Di Guglielmo, *supra* note 1, at 1506 (discussing trends in best practices and explaining that "counseling directors to 'do the right thing' is a proper function of the courts as well as counsel"); Corporate Director's Guidebook, *supra* note 9, at 3 (noting the link between conscientious conduct by directors and reduced risk of liability).

12. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) (holding that creditors of a corporation in the zone of insolvency may not assert direct claims for

interests of various stockholders differ, or when the stockholding body is transitory and not readily identifiable?[13] After all, the "corporation" consists of a variety of constituencies, including stockholders, and even stockholders certainly are not a unified group with identical interests. But, in Delaware, the directors' duties to stockholders must trump their concerns for other constituencies.[14] If the interests of the various constituencies differ and directors owe their fiduciary duties to the corporation, directors may be permitted to take into account the interests of other constituencies—or the corporation itself to the extent that the corporation's interest differs from that of the stockholders—when making board decisions.[15]

Fiduciary duties originated to protect stockholders, who own the corporation—in the sense that they own equity investments in the corporate entity—but have limited control over it.[16] Thus, where the corporation's interests cannot serve as a proxy for the stockholders' interests, are fiduciary duties best understood as owed to the stockholders? By owing their duties to the welfare of the corporate entity, directors may owe their duties primarily to stockholders because fiduciary duties

breach of fiduciary duty because they are protected by contract terms, fraudulent conveyance law, and other law, while fiduciary duties exist to protect stockholders). *But see* cases cited *supra* note 8 (reciting that directors' fiduciary duties run "to the corporation.").

13. *Cf.* ABA Section of Bus. Law, Comm. on Corporate Laws, *Guidelines for the Unaffiliated Director of the Controlled Corporation*, 45 Bus. Law. 429, 430 (1989) (evaluating the roles of "affiliated" as compared with "unaffiliated" directors of a controlled corporation and stating that "*[a]ll* directors have the same duties to the corporation and to *all* of its shareholders"); *cf. also* Phillips v. Insituform of N. Am., Inc., Civ. A. No. 9173, 1987 Del. Ch. LEXIS 474, at *30 (Aug. 27, 1987) ("[T]he law demands of directors . . . fidelity to the corporation and all of its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them . . . .").

14. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) ("[O]ur analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders.").

15. *See, e.g., Unocal*, 493 A.2d at 955 (stating that in responding to a takeover bid, directors may consider, among other things, "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)"); Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 Hastings L.J. 287, 297 (1996) ("Two celebrated Delaware cases support the discretion of directors under the business judgment rule to make the best decision for the corporation, even if the shareholders would have preferred other action."); Robert A. McCormick, *Union Representatives as Corporate Directors: The Challenge to the Adversarial Model of Labor Relations*, 15 U. Mich. J.L. Reform 219, 247 n.132 (1982) ("There is a division of authority regarding whether a corporate officer's fiduciary duty runs to the corporation as an entity, or to the shareholders themselves. The weight of authority, however, holds that a director's duty runs to the corporation. As a result, a majority of courts will not void a board decision that is fair and reasonable to the corporation, merely because a director with an outside interest participated in making the decision." (citations omitted)); *cf.* Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("The directors of Delaware corporations stand in a fiduciary relationship not only to the stockholders but also to the corporations upon whose boards they serve. . . . Although the fiduciary duty of a Delaware director is unremitting, the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders."). In some states, corporation law statutes explicitly require or permit directors to take into account the interests of non-stockholder constituencies when considering a takeover. *See* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 171–73 (1992) (providing an overview of such "other constituency" statutes).

16. *See Gheewalla*, 930 A.2d at 101 ("Delaware corporate law provides for a separation of control and ownership. The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners.' Accordingly, fiduciary duties are imposed upon the directors to regulate their conduct when they perform *that* function." (footnotes omitted)).

offer the only protection for stockholders' interests, while other constituencies may have other means (such as contractual provisions) of protecting their interests.[17]

Because of the contextual nature of the inquiry into constituency directors' fiduciary duties, the determination of the persons, entities, or constituencies to which directors owe their duties or their allegiances need not be made in a vacuum. Instead, that determination may be made by reference to the circumstances at issue and the nature of the divergence of interests that raises the question in the first place.

A constituency director should operate on the assumptions that: 1) she generally owes her fiduciary duties to both the corporation and its stockholders, and 2) when the interests of the corporation and the stockholders do not coincide, a judge assessing the director's liability for breach of fiduciary duty may have to develop some reasoned, equitable way of determining which interest takes precedence in a particular context. The contextual assessment will usually involve some balancing of interests, whether it be among various stockholders, between stockholders and other constituencies, or otherwise.

A reasoned, equitable approach will recognize that certain types of divergent interests that may at first appear to subject a constituency director to a conflict between the interests of his sponsor and his duty to the corporation and all the stockholders may not actually impose a conflict at all. A decision promoted by a labor representative on the board, for example, might increase labor costs—and increased costs might be seen by some as antithetical to stockholder interests in profits—but might nevertheless be in the company's long-term interests as promoting labor peace or increased productivity. That analysis invokes the time-honored principle of business judgment. The American Law Institute in its *Principles of Corporate Governance* explicitly recognizes that directors may focus on long-term profitability rather than short-term gain, and that the interests or expectations of a corporation's various constituencies impact long-term profitability:

> [T]hat the objective of the corporation is to conduct business activities with a view to enhancing corporate profit and shareholder gain[] does not mean that the objective of the corporation must be to realize corporate profit and shareholder gain in the short run. Indeed, the contrary is true: long-run profitability and shareholder gain are at the core of the economic objective. Activity that entails a short-run cost to achieve an appropriately greater long-run profit is therefore not a departure from the economic objective. An orientation toward lawful, ethical, and public-spirited activity will normally fall within this description. The modern corporation by its nature creates interdependencies with a variety of groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities in which the corporation operates. The long-term profitability of the corporation generally depends on meeting the fair expectations of such groups. Short-term profits may properly be subordinated to recognition that responsible maintenance

17. *See, e.g., id.* at 99 ("While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.").

of these interdependencies is likely to contribute to long-term corporate profit and shareholder gain. The corporation's business may be conducted accordingly.[18]

Thus, certain situations may implicate the duty to act in the best interests of the corporation as a whole, for the benefit of all those having an interest in it.[19] This approach would tend to emphasize long-term value over short-term gain, even if certain constituencies would prefer a short-term gain, while leaving room for the board to decide how to allocate value when circumstances require a trade off among constituencies.[20]

But this approach does not help in all contexts. In particular, it is not helpful when a director is on the board for the very purpose of representing or guarding the interests of a particular constituency, such as the preferred stockholders. If the sponsor's interests conflict with the interests of the corporation as a whole, the constituency director still faces a choice between abrogation of the duty to the corporation and abrogation of her role as representative of the interests of the sponsor. This is true even when that potentially parochial role may have been explicitly recognized by all involved when the director joined the board. For example, other directors and the stockholders will be on notice of (or will even have approved) a charter provision granting to preferred stockholders the right to designate one or more directors to the board. The interests of other constituents, such as labor, may be transparent and above board as well.[21] Disclosure of a potential conflict or fiduciary breach does not, however, mean that no conflict has arisen or that no breach has occurred. Instead, resolving a constituency director issue in such contexts will require a determination whether contractual or fiduciary principles trump.[22]

In short, no single paradigm will serve to resolve all constituency director issues. Instead, we have explored several possible conceptualizations of the

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

19. *See, e.g., Gheewalla*, 930 A.2d at 103 (describing the fiduciary duties of directors of an insolvent corporation as a "duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it"); *Unocal*, 493 A.2d at 954 ("[T]the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders . . . ."); Gouvin, *supra* note 15, at 294–95 ("Well-established law in Delaware and other jurisdictions holds that the directors of corporations owe fiduciary duties to both the corporation and its shareholders. The Delaware Supreme Court has recently stated that these two duties are 'of equal and independent significance,' but case law reveals that the directors' duty to the corporation as an entity usually predominates over their duty to the shareholders." (footnotes omitted) (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993))); *see also* E. Norman Veasey, *Counseling the Board of Directors of the Company in Distress*, Am. Bankr. Inst. J. (forthcoming 2008).

20. *Cf.* Corporate Director's Guidebook, *supra* note 9, at 2 ("In some cases, a board may even make a decision, in good faith, knowing that a substantial percentage of shareholders might disagree with that decision.").

21. Moscow, *supra* note 4, at 4 (discussing insistence of union president on Chrysler Corporation's board that the proxy statement disclose that he was joining the board to represent labor interests).

22. *Cf.* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 51 (Del. 1994) (explaining that fiduciary duties may not be limited or defined by contract); R. Franklin Balotti & A. Gilchrist Sparks, III, *Deal-Protection Measures and the Merger Recommendation*, 96 Nw. U. L. Rev. 467 (2002) (exploring the juxtaposition of contract and fiduciary principles in light of *QVC* and *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)). Consider also that preferred stockholders' rights may be grounded in a blend of contract and fiduciary principles. *Cf.* Kaiser Aluminum Corp. v. Matheson, 681 A.2d 392 (Del. 1996).

constituency director problem. Let us now consider how those conceptualizations might apply to potential scenarios in which constituency directors face a choice between acting in the interests of their constituencies and acting in the interests of the corporation or the stockholders as a whole.

III. Untangling Constituency Directors' Duties

In the BioMed scenario introduced above, the choice between the PipeDream loan and liquidation raises a conflict between the interests of the common stockholders and the interests of the preferred stockholders. Liquidation would lock in the common stockholders' losses and cut them off from any potential profit or reduction of their losses, while giving effect to the preferred stockholders' preference for cutting their losses and salvaging some value from their stock. The PipeDream transaction, on the other hand, would impose economic risks on the preferred stockholders for the benefit of the common stockholders.

The directors likely would not breach their fiduciary duties by choosing the PipeDream loan in an effort to secure some chance of fulfilling the company's business strategy. It appears that any duty of directors to any group other than the common stockholders is usually cumulative with the duty to the common stockholders—that is, duties to other groups may sometimes permit directors to take action that, on balance, favors a group other than the common stockholders, but a decision that favors the common stockholders generally will be upheld.[23] That does not answer the question, however, whether by choosing to liquidate the company, the directors would breach their fiduciary duties.[24] The essence of the business judgment rule is that it protects from judicial scrutiny the full range of rational, carefully made, disinterested, and independent business judgments.[25] An informed, disinterested board of directors could rationally

23. *Cf.* Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) ("While the facts out of which this dispute arises indisputably entail the imposition by the board of (or continuation of) economic risks upon the preferred stock which the holders of the preferred did not want, and while this board action was taken for the benefit largely of the common stock, those facts do not constitute a breach of duty."). While the BioMed scenario is based on the facts in *Equity-Linked*, the discussion in *Equity-Linked* of the duty of the directors to the common stockholders vis-à-vis the preferred stockholders is dicta. The plaintiff-preferred stockholders in *Equity-Linked*, perhaps recognizing the principle that directors of a corporation generally do not owe fiduciary duties to preferred stockholders, brought a claim under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1985). In that claim, the plaintiffs contended that the financing transaction in that case constituted a change of control transaction in which the directors owed a duty to the stockholders to obtain the best price reasonably available. The decision does not suggest that the preferred stockholders had any representatives on the board.

24. *See Equity-Linked*, 705 A.2d at 1042 ("[T]he board in these circumstances could have made a different business judgment . . . ."). *But cf. id.* ("The special protections offered to the preferred are contractual in nature. The corporation is, of course, required to respect those legal rights. But, aside from the insolvency point just alluded to, generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict." (citation omitted)).

25. *But cf.* Orban v. Field, Civ. A. No. 12820, 1997 Del. Ch. LEXIS 48, at *28–29 (Apr. 1, 1997) (assuming that the business judgment rule did not apply to a board's "authoriz[ation of] a non-pro-rata redemption of preferred shares for the purpose of funding the exercise by holders of preferred

decide that liquidating in order to provide some value to the preferred stockholders was the best available alternative, given the risks of continuing operations with the proceeds of the PipeDream loan.[26]

Because BioMed directors Adams and Breyer likely are not disinterested under these circumstances, however, traditional applications of the standards of review could subject their decision to liquidate to entire fairness review if their vote on the corporate action were to be the decision that prevailed.[27] But this approach would elevate their fiduciary duties to the common stockholders over their duties to the preferred stockholders, as well as the contractual understandings of the parties when the preferred stockholders received their right to elect two members of BioMed's board. So how could the law give effect both to the common stockholders' right to loyal fiduciaries and to the practical reality that large investors will sometimes insist on board representation in order to provide needed capital to a company?[28]

One possible approach would be to apply different rules in situations where there are public stockholders (who may lack information and opportunity to approve the structures that place and maintain constituency directors on the board) than in situations where there are fewer stockholders overall and no public stockholders.[29] This approach would emphasize the contractual understandings of the parties in the non-public company. In some situations, such as where a large infusion of cash occurs in a context requiring stockholder approval, *all* the stockholders—whether common, preferred, or different classes—understood that the director or directors elected by a particular constituency would represent the interests of that sponsor. If the director then openly promotes the sponsor's interests in her role as a director, attempts to persuade the other directors of the benefits of a particular decision (with disclosure to the other directors of the sponsor's interests), and votes to approve a decision that is in the sponsor's interests, imposing liability on that director

stock of warrants to buy common stock" in order to facilitate a merger in which the merger proceeds covered part of the value of the preferred stockholders' contractual preferences but left the common stockholders with nothing and stating that "[a] board may certainly deploy corporate power against its own shareholders in some circumstances—the greater good justifying the action—but when it does, it should be required to demonstrate that it acted both in good faith and reasonably").

26. *Cf. id.* at *32–33 (holding that directors did not breach a duty of loyalty by choosing a transaction that gave effect to the "existing legal preferences" of preferred stockholders because the common stockholders had "no legal right to a portion of the merger consideration under Delaware law or the corporate charter" and the transaction "appeared reasonably to be the best available transaction").

27. *See, e.g.*, Thorpe ex rel. Castleman v. CERBCO, Inc., 676 A.2d 436, 443 n.9 (Del. 1996) ("The premise of the entire fairness test is that the business judgment rule is inapplicable where self-interest may have colored directors' actions."); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (explaining that when a business decision is made by an interested or non-independent decision maker, the decision will be subject to entire fairness review).

28. Note the recent imbroglio reported in the *Wall Street Journal* involving the board of the Hershey company when its largest stockholder, the Hershey Trust, asserted rights to appoint or remove five of the corporation's six directors and effectively replaced with its own nominees the company directors with whom the Trust disagreed. *See* Julie Jargon, Matthew Karnitschnig & Joann S. Lublin, *How Hershey Went Sour*, Wall St. J., Feb. 23, 2008, at B1.

29. *Cf.* Model Bus. Corp. Act § 7.32 (2005) (authorizing shareholder agreements, approved by *all* shareholders, that modify default rules governing, for example, "the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation").

for acting in the sponsor's interests would be inconsistent with the parties' contractual expectations.[30] The better result under these circumstances seems to be that the constituency director should be permitted to promote and vote in favor of the sponsor's interests, so long as the board is aware of those interests and the entire board is involved in the decision-making process.[31] And, there is often the question whether the constituency directors actually caused, or were responsible for, a challenged corporate action if they did not constitute a majority of the board.

Corporation statutes may provide means to address certain situations that may raise constituency director issues. For example, section 122(17) of the Delaware General Corporation Law ("DGCL") permits a corporation to "[r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders."[32] Section 141(a) of the DGCL allows generally for modifications to the default statutory scheme "as may be otherwise provided in . . . [the] certificate of incorporation."[33] Certificate provisions authorized by section 122(17) or section 141(a) may be useful in dealing with specific, anticipated conflicts but likely have more limited utility in addressing the variety of circumstances that may arise once a constituency director is on the board. Moreover, because the law of fiduciary duty largely derives from case law, the viability of this approach to constituency director situations is uncertain to the extent that a particular situation has not been tested in litigation.

Alternative entity law provides another opportunity for creating a more nuanced, contract-based approach to fiduciary duties. Investors desiring to elevate contractual expectations over fiduciary duties may choose from a variety of other entity forms governed by legal regimes that emphasize a contract-oriented approach and permit modification or even elimination of fiduciary duties.[34] Such entity forms are particularly viable where there are so few parties in interest that the corporation would not have any public stockholders.

The contract-based approach does not merit the same consideration in a company with widely dispersed ownership because the public stockholders do not have the same opportunity to bargain regarding the contractual rights and may not

30. *See* Moscow, *supra* note 4, at 6 ("The basic assumption should be that most close corporation directors are representatives. At that extreme, self interested actions can be bounded by a fairness doctrine which would monitor conduct that reflects an abuse of power that is not within the expected range of the bargain of the shareholders.").

31. Contrast the board involvement in the suggested situation with usurpation of a corporate opportunity without disclosure to the board.

32. Del. Code Ann. tit. 8, § 122(17) (2001).

33. Del. Code Ann. tit. 8, § 141(a) (2001); *see also* Nixon v. Blackwell, 626 A.2d 1366, 1379–80 (Del. 1993) (observing that a purchasing minority stockholder may bargain for "definitive provisions of self-ordering" or other agreements to protect his or her position).

34. *See, e.g.*, Del. Code Ann. tit. 6, § 18-1101(c) (2005) (permitting an LLC agreement to expand, restrict, or eliminate the fiduciary duties of a member, manager, or other person otherwise owing fiduciary duties to an LLC or a member, manager, or other person bound to an LLC agreement); Del. Code Ann. tit. 6, § 17-1101(d) (2005) (same in limited partnership context).

have as much information as other constituencies have. Thus, it likely will not be appropriate to elevate contractual expectations above the directors' fiduciary duties to the common stockholders in a company with widely dispersed ownership.

But constituency directors might still be permitted opportunities to advance their sponsors' interests without violating their fiduciary duties to the corporate entity or to the common stockholders. For example, so long as the constituency directors' representative capacity is transparently disclosed to stockholders and fellow directors, constituency directors could be permitted to advocate the interests of their sponsors. That is, the constituency directors could attempt to persuade the entire board that their sponsors' interests represent or are aligned with the interests of the corporation and all its stockholders.

In this context, and as a matter of practicality, the constituency directors should perhaps consider the wisdom of abstaining from voting on a decision that presents a potential conflict between a constituency interest and the interests of the corporation and all the stockholders in order to avoid the risk that the decision-making process will be viewed as tainted by conflict and, thus, vulnerable to attack. Abstention would not be necessary to avoid liability because "directors can exercise their decision-making powers only by acting collectively,"[35] and the business judgment rule will not be rebutted if the interested directors do not constitute a majority of the directors approving the transaction.[36] But directors must exercise their judgment on an individual basis.[37] Abstention, therefore, might still be advisable in some circumstances because a director could not be certain, ex ante, how a reviewing court would view the independence and disinterestedness of all the members of the board if the transaction were challenged.

Professor Joseph Hinsey has suggested an approach to the constituency director problem that would permit the constituency director to advocate the constituent's interest but require that he or she abstain from voting on a matter that favors the constituency:

> While perhaps not an exception, an adjustment re [constituency directors'] duties and fealty—arguably not totally unreasonable—might be considered; that is, shouldn't [constituency directors] be entitled to advocate their sponsors' parochial interests during boardroom deliberations? If acceptable, any such concession must obviously be qualified by the requirement that there be made full disclosure vis-à-vis the [constituency director's] bias. However, that concession should not extend to voting. If a sponsor's parochial interests translate into transactional conflict, then the [constituency director] should invoke the common law procedures for director conflict (i.e., disclosure/recusal) or a corporate statute's provisions *re* directors' conflicting interest transactions (see Model Act section 8.60 *et seq.*). If not, then the situation becomes a

35. Corporate Director's Guidebook, *supra* note 9, at 1487.

36. *See* Aronson v. Lewis, 473 A.2d 805, 812, 814 (Del. 1984); *cf. also* Del. Code Ann. tit. 8, § 144 (2001).

37. Corporate Director's Guidebook, *supra* note 9, at 1487; *cf. also In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005) (noting the recent understanding in Delaware case law that director liability determinations must be made on a director-by-director basis), *aff'd*, 906 A.2d 27 (Del. 2006).

> matter for the boardroom's anecdotal evaluation. Relevant thereto, the "shareholder value" justification will often call for caution. For example, the paring of R&D will typically enhance current earnings—translating into market price appreciation that will benefit all shareholders (and, by the same token, implement a sponsor's "hidden agenda" *re* an exit strategy for the liquidation of the LBO investment) *but* reducing R&D may not be in the corporation's best interest.[38]

Whether advocacy or approval is permitted, it is clear that disclosure of the constituency ties is critical in all contexts.[39] Yet, while disclosure will generally be necessary to fulfillment of a constituency director's duties, it may not be sufficient in certain circumstances.

The BioMed scenario presents a situation in which—because of the supermajority voting requirement—the constituency directors' votes are necessary to achieving a transaction even though the constituency directors constitute less than a majority of the board. But when constituency directors comprise less than a majority of the board (or less than a majority of the directors voting on a particular matter), then more typically, at least in the decision-making context, no issue of liability will even arise for litigation because a majority of the board will be disinterested in the transaction.[40] Thus, constituency directors may take some comfort, despite any tension between their duties to their sponsors and their fiduciary duties, if constituency directors comprise less than a majority of the board on which they serve. As noted above, however, which directors should be deemed disinterested and independent cannot always be determined ex ante because, in Delaware, the inquiry into independence and disinterest depends on the circumstances.[41] Such structural considerations therefore do not guarantee protection from liability.

Moreover, situations can arise that implicate constituency directors' fiduciary duties in a non-decision-making context. For example, suppose Adams and Breyer were to inform the preferred stockholders that the BioMed board was evaluating a choice between the PipeDream loan and liquidation, or even to share with the preferred stockholders reports or analytical materials or advice prepared for the board in connection with the search for alternatives. It seems clear that such

38. Posting of Joseph Hinsey to the Harvard Law School Corporate Governance Blog, http://blogs.law.harvard.edu/corpgov/2008/01/14/the-constituency-director (Jan. 14, 2008, 15:26 EST) ("The Constituency Director"); *see also* Moscow, *supra* note 4, at 2 ("The problem arises under the corporate norm when expected advocacy by a representative director evolves into action of the director, whether in considering transactions with the sponsor, a veto of a corporate action, information sharing or other actions that may benefit the sponsor.").

39. *See* Moscow, *supra* note 4, at 4 (discussing proxy disclosures of Chrysler Corporation regarding role of UAW's representative on the Chrysler board).

40. *See, e.g.*, Del. Code Ann. tit. 8, § 144(a) (2001) (providing that an interested director transaction shall not be void or voidable solely because the interested director participates in the decision-making process or votes in favor of the transaction, if the director's interest is disclosed to the board and a majority of the disinterested directors approve the transaction); *Aronson*, 473 A.2d at 812 ("[I]f such director interest is present, and the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application whatever in determining demand futility."); *id.* at 814 (holding that demand will be futile and therefore excused under Court of Chancery Rule 23.1 if a majority of the board approving a challenged transaction was interested in the transaction).

41. *See, e.g.*, Beam v. Stewart, 845 A.2d 1040 (Del. 2004).

conduct would violate the directors' duty to protect BioMed's confidential information.[42] Yet that result might also seem inconsistent with the parties' understanding that Adams and Breyer were on the board to be the preferred stockholders' eyes and ears and to represent and protect their interests. Resolving that tension again requires resolving the tension between contractual and fiduciary principles. In the context of a corporation operating under default corporation law rules, that latter tension should usually be resolved in favor of fiduciary principles, especially in a legal system that offers a variety of entity forms—with varying emphasis on contract and fiduciary principles—from which to choose.

Conclusion

Practitioners and other commentators have expressed concern that extant fiduciary duty principles are not adequately flexible to allow constituency directors to fulfill their fiduciary duties while simultaneously carrying out the purposes for which their sponsors place them on corporate boards.[43] Those observers lament that this arguable inflexibility will impair capital formation or otherwise limit the range of financing and strategic alternatives available to businesses.[44] But such concerns may be largely academic in the decision-making context. The business judgment rule and provisions such as DGCL section 144 will protect even interested directors and transactions so long as the interested directors are not a majority of the board. The frequency with which situations will arise in which constituency directors comprise a majority of the board is likely low. The BioMed scenario used as a framework for discussion in this Article reflects this reality, as it is only because of the supermajority voting provision that the constituency-director minority faced a potential question of causing corporate decisions to favor their sponsor.

To the extent that constituency directors do confront real tensions between their fiduciary duties and the expectations of their sponsors, constituency directors should bear a few ideas in mind. Directors will generally be responsible for protecting the best interests of the corporation and all its stockholders, despite the directors' designation by some particular constituency, because fiduciary duties generally will trump contractual expectations in the corporate context. Constituency directors may face greater risks of liability for breach of fiduciary duty if constituency directors constitute a majority of the board than if they are only a

42. For cases outlining the parameters of directors' duty to protect confidential information, see, for example, *Malone v. Brincat*, 722 A.2d 5, 12 (Del. 1998); *Stroud v. Grace*, 606 A.2d 75, 89 (Del. 1992); *In re Oracle Corp. Derivative Litigation*, Civ. A. No. 18751, 2004 Del. Ch. LEXIS 173, at *90 (Nov. 24, 2004); *Lazard Debt Recovery GP, LLC v. Weinstock*, Civ. A. No. 19053, 2004 Del. Ch. LEXIS 109 (Aug. 6, 2004); *Hollinger International v. Black*, 844 A.2d 1022, 1061–62 (Del. Ch. 2004); and *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. Ch. 1949).

43. *See, e.g.*, Moscow, *supra* note 4, at 5, 7 (describing the duty of loyalty standard as "rigid" and stating that "the standard corporate model is simplistic and unworkable as a rigid guide").

44. *See, e.g.*, Woolf, *supra* note 4, at 473 (suggesting that application of the traditional fiduciary duty standards in the venture capital context "has the potential to harm capital formation and business development" because the standards are based on an "anachronistic and ineffectual" "notion that directors and officers owe their undivided loyalty to a single company and its shareholders").

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minority of the board. Individuals should consider the structure of the board when deciding whether to join a board as a constituency director. Once on the board, constituency directors might do well to abstain from voting on a matter before the board that presents a potential conflict between the interests of the corporation and its stockholders and the interests of the sponsor or constituency group.

Alternative entity laws, charter variations, or stockholder agreements provide additional options for circumstances requiring the primacy of contractual expectations over fiduciary principles. Yet, even in the "plain vanilla" corporate context there may be a role for constituency directors to advocate the interests of their sponsors and to provide their sponsors with a stronger "voice" in corporate affairs.

While constituency directors can provide their sponsors with a voice in the boardroom, they should not expect to be their sponsors' eyes and ears in all circumstances. Constituency directors may breach their fiduciary duty of loyalty by transmitting confidential corporate information to their sponsors despite any contractual expectations to the contrary. And corporation law provides no "safety in numbers" for this type of breach of fiduciary duty.

In the end, whether in the decision-making context or in some other setting, the primary basis upon which a constituency director's conduct will be measured is whether the director's decision is based upon the corporate merits of the subject before the board, rather than extraneous considerations or influences.[45]

45. *Cf.* Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) ("The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences.").