

THE CONTROLLING SHAREHOLDER'S GENERAL DUTY OF CARE: A DOGMA THAT SHOULD BE ABANDONED

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It is a frequently repeated dogma in corporate law that controlling shareholders have a general fiduciary duty of care towards the corporation. This Essay, however, argues that the case for such a duty is exceedingly weak.

Given that controlling shareholders are heavily invested in the controlled corporation, they already have a strong financial incentive to make well-informed decisions. Accordingly, there is no need for a general duty of care. In fact, the general duty of care for corporate controllers owes its existence to little more than poor doctrinal reasoning: courts have suggested that, in order to protect minority shareholders, corporate controllers who direct the actions of the corporation must assume the fiduciary duties of corporate directors. This argument, however, is flawed for many reasons. In particular, it overlooks the fact that controlling shareholders and corporate directors face vastly different incentives.

It is time, therefore, to abandon this line of reasoning and, with it, the idea of a general duty of care for corporate controllers.

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I. INTRODUCTION

Controlling shareholders, who direct the actions of the board, are generally thought to have a fiduciary duty of care towards the corporation.¹ This duty of care is particularly uncontroversial in Delaware, the state that serves as a legal domicile to more than half of all existing public corporations² and to almost ninety percent of those corporations that have gone public in recent years.³ In a famous dictum, the Delaware Chancery Court described the controller's duty of care as follows:

[W]hen a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of the

1. Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072, 1130 n.176 (1983); Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies*, 6 N.C. J.L. & TECH. 223, 255 (2005) (referring specifically to Delaware law); Ely R. Levy, *Freeze-Out Transactions the Pure Way: Reconciling Judicial Asymmetry Between Tender Offers and Negotiated Mergers*, 106 W. VA. L. REV. 305, 321 (2004); Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After more than a Decade of Experimentation?*, 32 J. CORP. L. 565, 573 (2007); J. Haskell Murray, *"Latchkey Corporations": Fiduciary Duties in Wholly Owned, Financially Troubled Subsidiaries*, 36 DEL. J. CORP. L. 577, 598 (2011); Laurence V. Parker, Jr., *Virginia Is for Lovers and Directors: Important Differences Between Fiduciary Duties in Virginia and Delaware*, 2 WM. & MARY BUS. L. REV. 51, 57 (2011); D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1045 n.28 (1996); Nelson Ferebee Taylor, *Evolution of Corporate Combination Law: Policy Issues and Constitutional Questions*, 76 N.C. L. REV. 687, 797-99 (1998); TaeRa K. Franklin, Practitioner Note, *Deepening Insolvency: What It Is and Why It Should Prevail*, 2 N.Y.U. J.L. & BUS. 435, 459 (2006); Marc R. Lisker, Note, *NoDak Bancorporation v. Clarke: The Eighth Circuit's Ruling on Freeze-Out Mergers Sends a Chill to Minority Shareholders*, 89 NW. U. L. REV. 318, 345 (1994). For a slightly more cautiously worded position, see Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1265 n.26 (2008), noting that "[i]n some circumstances, shareholders have been held to have a duty of care." *But see* Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 137 F. Supp. 2d 502, 514 (S.D.N.Y. 2001) ("Delaware law does not seem to impose a duty of care on controlling shareholders in cases in which there is no breach of the duty of loyalty.").

2. *About Agency*, DEL. DIV. OF CORPORATIONS, <http://www.corp.delaware.gov/aboutagency.shtml> (last visited October 15, 2014).

3. Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J.L. ECON. & ORG. 79, 87 (2011).

corporation. When, on the other hand, a majority shareholder takes no such action, generally no special duty will be imposed.⁴

The Delaware Supreme Court has cited this passage with approval as recently as 2009,⁵ and the controlling shareholder's duty of care is now widely regarded as one of the unassailable pillars of Delaware corporate law.⁶ To quote two of this nation's most eminent corporate law scholars, "Delaware law is clear that when a controlling shareholder exercises control over business decisions, the shareholder takes on the same duties of care that other fiduciaries have."⁷

Despite this impressive consensus, the assumption of a general duty of care for controlling shareholders is erroneous. As a matter of legal policy, there is no need for the imposition of such a duty. Unlike corporate directors, controlling shareholders are heavily invested in the corporation. This being the case, they already have strong financial incentives to make informed decisions in the best interest of their corporations, making it unnecessary to impose a duty requiring them to do so.

In fact, the assumption of a general duty of care for corporate controllers rests on little more than a doctrinal misstep. Like courts in other states, Delaware courts understood early on that minority shareholders needed to be protected against opportunistic behavior by controlling shareholders, and that imposing a duty of loyalty was an effective way to ensure that this need was met.⁸

Instead of offering an economic or policy-oriented justification for the imposition of such a duty of loyalty, however, Delaware courts took the more doctrinal approach of invoking what I will call the "assumption argument." Typically, it is the board that manages, or supervises the management of, the corporation.⁹ If a corporation has a controlling shareholder who directs the actions of the board, then the shareholders

4. *Cinerama, Inc. v. Technicolor, Inc.*, Civ. A. No. 8358, 1991 WL 111134, at *19 (Del. Ch. June 24, 1991), *aff'd in part, rev'd on other grounds sub nom. Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

5. *Pfeffer v. Redstone*, 965 A.2d 676, 691 n.52 (Del. 2009).

6. See sources cited *supra* note 1.

7. Marcel Kahan and Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293, 1321 (2011).

8. Delaware cases applying the duty of loyalty to controlling shareholders go back to at least the first half of the twentieth century. See, e.g., *Allied Chemical & Dye Corp. v. Steel & Tube Co.*, 120 A. 486, 489 (Del. Ch. 1923) ("The same considerations of fundamental justice which impose a fiduciary character upon the relationship of the directors to the stockholder will also impose, in a proper case, a like character upon the relationship which the majority of the stockholders bear to the minority. When . . . a majority of the voting power in the corporation join hands in imposing its policy upon all . . . it seems to me . . . to take any view other than that they are to be regarded as having placed upon themselves the same sort of fiduciary character which the law impresses upon the directors in their relation to all the stockholders."); *Hartford Accident & Indem. Co. v. W. S. Dickey Clay Mfg. Co.*, 21 A.2d 178, 184 (Del. Ch. 1941) (holding that controlling shareholders must exercise their right to amend the charter "with fair and impartial regard for the rights and interests of all of the corporate stockholders of every class" if they are to avoid "a breach of the fiduciary relation occupied by the majority stockholders toward the minority").

9. DEL. CODE ANN. tit. 8, § 141 (2014).

lose the protection that the board offers.¹⁰ The argument goes that, in order to maintain shareholder protection in such situations, the controlling shareholder must assume the board members' fiduciary duties.¹¹ The obvious doctrinal implication of this line of reasoning is that the controlling shareholder inherits the board's fiduciary duties, and these include both the duty of loyalty and the duty of care.¹²

The assumption argument, however, has a number of critical flaws. Perhaps most importantly, it simply ignores the different incentives that corporate directors and controlling shareholders face. Given that controlling shareholders have powerful financial incentives to make well-informed decisions, it is not clear why a general duty of care is needed to protect minority shareholders. Other problems with the assumption argument include the facts that it fits poorly with the so-called "looting doctrine,"¹³ is inconsistent with the Delaware case law on the duty of loyalty, and leads to bizarre consequences with respect to so-called "exculpation clauses." In light of these problems, Delaware courts would be well-advised to abandon the assumption argument and, with it, the notion of a general duty of care for corporate controllers.

A clarification is in order at this point. When this Essay argues against a *general* duty of care for controlling shareholders, the use of the term "general" is quite deliberate. This is because there are, in fact, two narrowly defined scenarios where the imposition of a duty of care can be justified. One concerns so-called "looting cases" where a controller sells his controlling stake despite red flags indicating that the acquirer will proceed to loot the corporation.¹⁴ The second scenario involves cases where the controller enjoys control of the corporation without corresponding economic ownership.¹⁵ Both these situations are exceptional in the sense that the controlling shareholder, for once, may not have sufficient economic incentives to act with due care when exercising his control over the corporation. In the looting scenario, the selling controller typically no longer owns any shares in the corporation when the looting occurs. Similarly, where the controlling shareholder formally owns his shares, but is not their economic owner, he fails to feel the economic consequences of his actions.

Setting aside these two exceptional scenarios, there is simply no persuasive justification for a general duty of care for controlling shareholders. Accordingly, courts should reject such a duty. Such a move is further encouraged by the fact that there is scant precedential support for the existence of a general fiduciary duty of care for controlling share-

10. *Cinerama, Inc. v. Technicolor, Inc.*, Civ. A. No. 8358, 1991 WL 111134, at *19 (Del. Ch. June 24, 1991), *aff'd in part, rev'd on other grounds sub nom. Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

11. *Id.*

12. *Id.*

13. *See infra* Part II.B.2 (defining the "looting doctrine").

14. *See infra* Part II.B.2.

15. *See infra* Part II.B.3.

holders;¹⁶ numerous dicta notwithstanding,¹⁷ no Delaware court has ever found a controlling shareholder liable for violating his general duty of care.

Aside from its obvious theoretical interest, the issue raised in this Essay has substantial practical importance. The economic significance of the law governing controlling shareholders is steadily increasing. Firms with controlling shareholders are a minority among publicly traded corporations, but their numbers are on the rise. A 2012 study of S&P 1500 companies found that about eight percent of these companies had a controlling shareholder, up from six percent in 2002.¹⁸ Even more importantly, controlling shareholders are a standard feature of privately held corporations.¹⁹ For example, one recent study focusing on a sample of 2776 privately held corporations found that, of the firms with more than one shareholder, over seventy percent had a primary owner with an ownership stake of fifty percent or more.²⁰ This matters because the relative economic significance of privately held firms is growing: whereas the number of publicly traded corporations in the United States declined by half between 1997 and 2009,²¹ privately held firms now account for more than half of all private-sector output.²²

Moreover, the duty of care for corporate controllers, depending on how strictly it is applied, has substantial potential legal significance. For corporate directors, the relevance of this duty has declined,²³ not least

16. See *infra* Part III.

17. See *infra* Part III.B.

18. IRRIC INST., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 3 (2012).

19. Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1291–92 (2002) (noting that “close corporation ownership is generally highly concentrated” and suggesting that “a corporation lacking a shareholder with capacity to control is unlikely to occur in the universe of close corporations”); Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 DEL. J. CORP. L. 377, 384 (2004) (noting that “close corporations often either have a controlling shareholder or, given the small number of shareholders, can more easily form a control group”).

20. See Venky Nagar et al., *Governance Problems in Closely Held Corporations*, 46 J. FIN. & QUANTITATIVE ANALYSIS 943, 954 tbl. 3 (2011) (own calculations based on the data presented in table 3, given that $(0.933*919+0.585*359+0.573*211+0.544*114+0.328*323)/(2776-850)=0.704$).

21. Gerald F. Davis, *The Twilight of the Berle and Means Corporation*, 34 SEATTLE U. L. REV. 1121, 1134 (2011).

22. Ted. D. Englebrecht et al., *An Empirical Assist in Determining Reasonable Compensation in Closely Held Corporations*, 30 J. APPLIED BUS. RES. 233, 233 (2014); Venky Nagar et al., *supra* note 20, at 944.

23. See, e.g., Steven A. Ramirez, *The Special Interest Race to CEO Primacy and the End of Corporate Governance Law*, 32 DEL. J. CORP. L. 345, 358 n.65 (2007) (noting that in practice “the duty of care seldom triggers manager liability”). It is sometimes pointed out that, even in the seventies, before the states had enacted exculpation statutes, directors were rarely held liable for duty-of-care violations. See, e.g., Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 978 (noting that “[c]ommentators who surveyed duty of care decisional law through the 1970s identified only a handful of cases outside the context of financial institutions in which directors of business corporations had been found liable for breach of their duty of care”). In the famous *Van Gorkom* decision, the Delaware Supreme Court moved to a much more aggressive interpretation of the duty of care, holding directors liable for conduct that hardly seemed to justify the verdict of gross negligence that the Chancery Supreme bestowed on it. See *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (finding a duty of care violation); Morton Moskin, *Trans*

because most states, led by Delaware, allow for corporate charters to waive the liability of corporate directors for duty-of-care violations.²⁴ At least in public corporations, corporate charters now routinely include such exculpation clauses,²⁵ making corporate directors' duties of care largely irrelevant.²⁶ The relevant statutes do not, however, or at least do not explicitly, allow exculpation provisions benefiting controlling share-

Union: *A Nailed Board*, 10 DEL. J. CORP. L. 405, 405 (1985) (arguing that, in *Van Gorkom*, the "Delaware Supreme Court . . . dramatically confirmed that even an experienced board of directors" may not be protected by the business judgment rule); Steven F. Mones, Comment, *Mining the Safe Harbor? The Business Judgment Rule After Trans Union*, 10 DEL. J. CORP. L. 545, 568 (1985) (reading the *Van Gorkom* decision as "a forceful statement to corporate directors that the business judgment rule is not an impenetrable shield" and seeing the decision as an indication "that in the future it will examine the factual circumstances surrounding boards' decisions with a higher degree of scrutiny"). Hence, the duty of care would have imposed substantial restraints on corporate directors had the states not rushed to enact exculpation statutes.

24. *E.g.*, Charles M. Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 583 (2002). Some of these statutes are based directly on the Delaware exculpation statute. ALASKA STAT. § 10.06.210(1)(N) (2012); ARK. CODE ANN. § 4-27-202(B)(3) (2012); COLO. REV. STAT. § 7-108-402 (2012); 805 ILL. COMP. STAT. 5/2.10(b)(3) (2012); KAN. STAT. ANN. § 17-6002(b)(8) (2011); KY. REV. STAT. ANN. § 271B.2-020(2)(d) (2012); LA. REV. STAT. ANN. § 12:24(c)(4) (2012); MASS. GEN. LAWS ch. 156B, § 13(b) (2012); MINN. STAT. § 302A.251(4) (2012); MO. REV. STAT. § 351.055(2)(3) (2012); N.J. REV. STAT. § 14A:2-7(3) (2012); N.D. CENT. CODE § 10-19.1-50(5) (2012); OKLA. STAT. tit. 18 § 1006(b)(7) (2012); OR. REV. STAT. § 60.047(2)(d) (2011); R.I. GEN. LAWS § 7-1.2-202(b)(3) (2012); S.C. CODE ANN. § 33-2-102(e) (2011); TEX. BUS. ORGS. CODE ANN. § 7.001(c) (West 2012). Other statutes follow the approach taken by the Model Business Corporation Act. ARIZ. REV. STAT. ANN. § 10-202(B)(1) (2012); D.C. CODE § 29-302.02(b)(4) (2012); HAW. REV. STAT. § 414-222 (2012); IDAHO CODE ANN. § 30-1-202(2)(d) (2012); IOWA CODE § 490.202(2)(d) (2012); MICH. COMP. LAWS § 450.1209(1)(c) (2012); MISS. CODE ANN. § 79-4-2.02(b)(4) (2012); MONT. CODE ANN., § 35-1-216(2)(d) (2011); NEB. REV. STAT. § 21-2018(2)(d) (2012); N.H. REV. STAT. ANN. § 293-A:2.02(b)(4) (2012); S.D. CODIFIED LAWS § 47-1A-202.1(4) (2012); VA. CODE ANN. § 13.1-692.1(A)(1) (2012); WYO. STAT. ANN. § 17-16-202(b)(4) (2012). Some states have taken more idiosyncratic approaches. In New Mexico, for example, the personal liability of directors cannot be eliminated for mere duty-of-care violations if the director received more than \$2000 annually or owned shares in the corporation. N.M. STAT. ANN. § 53-12-2(e)(2)(a) (2012). For an analysis of the trend towards enacting exculpation statutes in the wake of the *Van Gorkom* decision, see Gordon Moodie, *Forty Years of Charter Competition: A Race to Protect Directors from Liability?* (John M. Olin Center for Law, Economics, and Business Fellow's Discussion Paper Series, Discussion Paper No. 1, 2004), available at http://www.law.harvard.edu/programs/olin_center/fellows_papers/1_Moodie.php.

25. *See, e.g.*, Todd M. Aman, *Cost-Benefit Analysis of the Business Judgment Rule: A Critique in Light of the Financial Meltdown*, 74 ALB. L. REV. 1, 19 (2010) (noting the "widespread inclusion of director exculpation provisions in corporate charters"); Elson & Thompson, *supra* note 24, at 583 (noting that "almost all" corporations have adopted exculpation clauses); Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1703 (2007) (noting that exculpation provisions are common in corporate charters). Empirical studies confirm this view. Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 497 app. A (2000) (examining the charters of one-hundred large public corporations and finding that only ten of them did not include an exculpation clause); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160-61 (1990) (analyzing 180 corporate charters of public corporations and finding that over ninety percent of them contained an exculpation clause).

26. I say "largely irrelevant" because, even for directors in corporations with exculpation clauses, there are scenarios in which the duty of care matters. Perhaps most importantly, an exculpation clause under section 107(b) of the Delaware General Corporation Law can eliminate the director's personal liability for a duty-of-care violation, but does not prevent shareholders from seeking a preliminary injunction to prevent the relevant transaction in the first place. *E.g.*, *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 838 (Del. Ch. 2011); *Police & Fire Ret. Sys. of Detroit v. Bernal*, Civ. A. No. 4663-CC, 2009 WL 1873144, at *2 (Del. Ch. June 26, 2009).

holders.²⁷ It is therefore often dubious whether controlling shareholders' liability can also be waived.²⁸

The case for the potential legal significance of the controller's duty of care is further bolstered by the fact that this duty is not limited to corporate law in the strict sense. Rather, a recent Delaware case makes it clear that fiduciary duties also apply to the controlling owner of a limited liability company.²⁹

This Essay proceeds as follows: Part II explains why a general duty of care for corporate controllers is undesirable as a matter of legal policy. Part III analyzes the relevant case law. In particular, Part III shows that no Delaware court has ever held a controlling shareholder liable for a violation of his general duty of care. Moreover, while there are various dicta recognizing a general duty of care for controlling shareholders, these dicta rest almost exclusively on the single doctrinal argument which I have termed the "assumption argument." Part IV then proceeds to debunk the assumption argument by showing that it is logically flawed, inconsistent with the court's own case law, and apt to lead to absurd consequences. Part V includes a summary and some concluding remarks.

II. THE POLICY CASE AGAINST THE DUTY OF CARE

While both Delaware courts³⁰ and commentators³¹ embrace a general duty of care for controlling shareholders, the policy case for such a duty is exceedingly weak.

A. Costs

The costs of imposing such a general duty of loyalty on corporate controllers are clear. Like any fiduciary duty, it has the potential to provoke frivolous litigation,³² which then gets settled not because of its mer-

27. See sources cited *supra* note 24.

28. A recent Delaware Chancery Court decision holds that controlling shareholders cannot be held liable for duty-of-care violations to the extent that the corporation's directors are protected by an exculpation clause. *Shandler v. DLJ Merch. Banking, Inc.*, Civ. A. No. 4797-VCS, 2010 WL 2929654, at *16 (Del. Ch. July 26, 2010). It remains to be seen whether the Delaware Supreme Court, as well as courts in other jurisdictions, will follow this line of reasoning.

29. *Kelly v. Blum*, Civ. A. No. 4516-VCP, 2010 WL 629850, at *12 (Del. Ch. Feb. 24, 2010) (holding that "controlling members in a member-managed LLC owe minority members 'the traditional fiduciary duties' that controlling shareholders owe minority shareholders"); *In re Atlas Energy Res., LLC*, Civ. A. No. 4589-VCN, 2010 WL 4273122, at *7 (Del. Ch. Oct. 28, 2010) (holding that "in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, controlling members in a manager-managed LLC owe minority members the traditional fiduciary duties that controlling shareholders owe minority shareholders" (quoting *Kelly*, 2010 WL 629850, at *12)).

30. See discussion *infra* Part II.

31. See sources cited *supra* note 1.

32. Cf. Benjamin D. Landry, *Mutual Assent in the Corporate Contract: Forum Selection Bylaws*, 18 *FORDHAM J. CORP. & FIN. L.* 889, 892 (2013) (noting that "the costs of defending duplicative and frivolous multijurisdictional stockholder lawsuits have, in recent years, become increasingly high").

its, but because of its nuisance value.³³ In practice, it is already the case that any merger or other fundamental transaction between a public corporation and its controlling shareholder may prompt suits against the controlling shareholder as well as against the directors of the controlled corporation.³⁴ This situation would likely get much worse if the Delaware courts ever granted damages based on a controlling shareholder's violation of their general duty of care, as one could then expect allegations of duty-of-care violations to be routinely thrown into the mix. Indeed, the rather spurious allegations of misconduct underlying some of the cases discussed in Part III of this Essay aptly demonstrate the duty of care's potential for abuse.³⁵

Moreover, at the margin, the existence of a duty of care may deter some large shareholders from intervening where such interventions would be in the best interest of the company. By and large, corporate law scholars tend to agree that it is desirable that large blockholders play an active role in monitoring corporate management, and intervene where necessary.³⁶ At the margin, however, such blockholders will be less enthusiastic about playing an active role in monitoring the corporation if their interventions are likely to prompt litigation for alleged duty-of-care

33. Cf. Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice During a National Crisis*, 17 GEO. MASON L. REV. 661, 693 (2010) (noting that "[f]rivolous cases are sometimes settled for positive value"); Clark W. Furlow, *Back to Basics: Harmonizing Delaware's Law Governing Going Private Transactions*, 40 AKRON L. REV. 85, 86 (2007) (pointing out that even frivolous claims "brought under the entire fairness standard cannot be disposed of without a trial, and the trial of such claims is invariably complex and expensive").

34. This problem has traditionally been exacerbated by the traditional use of the entire fairness standard in freeze-out mergers. Cf. *In re Cox Commc'ns., Inc. S'holders Litig.*, 879 A.2d 604, 620–21 (Del. Ch. 2010) (analyzing the problem of frivolous litigation in the context of mergers involving controlling shareholders). More recently, the Delaware Supreme Court has held that long-form freeze-out mergers between a parent and its subsidiary are subject to the entire fairness standard if "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014). Whether this move will reduce the number of frivolous lawsuits remains to be seen.

35. See, e.g., *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 752 (Del. Ch. 2006) (noting that the "complaint is devoid of facts supporting a rational inference that the controller should have suspected that the buyer, another listed public company, had plans to extract illegal rents from the subsidiary").

36. See, e.g., Ian Ayres & Peter Crampton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1035 (1994) (arguing that large block holders have better incentives to monitor than small shareholders and pointing out that such monitoring can reduce agency costs between management and shareholders); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785 (2003) (arguing that "the presence of a large shareholder may better police management than the standard panoply of market-oriented techniques"); Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-off*, 108 COLUM. L. REV. 749, 751 (2008) (noting that "a host of scholars and policy-makers have come to embrace the utility of monitoring by blockholders"); Dale A. Oesterle, *The Rise and Fall of Street Sweep Takeovers*, 1989 DUKE L.J. 202, 254 (1989) ("Large block holders are better able to monitor managers' actions and reduce the transaction costs of control changes."). The empirical literature also tends to confirm that the presence of large blockholders benefits the corporation. E.g., Michael J. Barclay & Clifford G. Holderness, *The Law and Large-Block Trades*, 35 J.L. & ECON. 265, 268–69 (1992); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 470 (1986).

violations. To be sure, under the prevailing view, the duty of care applies only to controlling shareholders and not to other large shareholders whose power stops short of actual control.³⁷ The distinction between a large blockholder engaged in monitoring management and a controlling shareholder, however, can be unclear. This is because Delaware law defines the concept of control generously: in order to be considered a controlling shareholder, ownership of a majority interest is sufficient³⁸ but by no means necessary. Rather, a shareholder will be deemed a controlling shareholder as long as he enjoys *de facto* control of the corporation.³⁹ Unsurprisingly, the test for *de facto* control, “domination . . . through actual control of corporation conduct,”⁴⁰ constitutes a rather vague standard, making the outcome of its application difficult to predict. Compounding this uncertainty is the fact that several shareholders, none of whom control the corporation individually, are sometimes classified as a controlling group.⁴¹ Unfortunately, Delaware courts have never defined exactly how much coordination or cross-ownership is necessary for two or more shareholders to constitute a group in this sense. As a result, large blockholders cannot always be sure whether or not they will be judged to control the corporation.

B. Benefits

Whereas the costs of imposing a general duty of care are clear, the benefits of such a duty are far from obvious. In most cases, the controlling shareholder already has a very powerful reason to become reasonably informed before making decisions: Badly informed decisions are likely to reduce the value of the corporation and, hence, of the controlling shareholder's investment. There are two narrowly defined exceptions to this rule, namely sales to potential looters and lack of economic ownership,⁴² and these exceptions will be discussed in more detail below.

1. The Typical Case

In the vast majority of cases, the majority shareholder is the one to suffer most as a result of any careless decision that he makes regarding the corporation's management. Typically, the controlling shareholder is

37. See sources cited *supra* notes 1, 4, and 5.

38. See *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1113–14 (Del. 1994); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987).

39. *Kahn*, 638 A.2d at 1114; *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989); *Ivanhoe Partners*, 535 A.2d at 1344; Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 474 n.128 (2008).

40. *Kahn*, 638 A.2d at 1114 (quoting *Citron*, 569 A.2d at 70).

41. *E.g.*, *Thorpe ex rel. Castleman v. CERBCO, Inc.*, 676 A.2d 436, 438 (Del. 1996) (finding the existence of a controlling group of shareholders without defining what it takes for several shareholders to be considered a group); *In re Allion Healthcare Inc. S'holders Litig.*, Civ. A. No. No. 5022-CC, 2011 WL 1135016, at *1 (Del. Ch. Mar. 29, 2011) (finding a controlling group without defining the concept of group).

42. See discussion *infra* Parts II.B.2–3.

the owner with the greatest ownership stake.⁴³ This being the case, he has a very good reason to become informed even in the absence of any duty of care.

Indeed, it is helpful to compare the incentives of the controlling shareholder to those of the typical outside director. Despite the fact that outside directors are assigned a crucial role in corporate governance,⁴⁴ their economic incentives to apply due care in exercising their duties are actually quite limited. There are essentially two incentives for outside directors to exercise due care: concern about their reputation⁴⁵ and about the threat of personal liability.⁴⁶ Neither of these incentives, however, seems particularly powerful compared to the incentive that the controlling shareholder faces, namely the economic loss he may incur as a result of poor management.

In particular, the outside director's risk of being held personally liable for duty-of-care violations is all but nonexistent. Most importantly, the charters of most public corporations include so-called "exculpation clauses" that eliminate the liability of directors for duty-of-care violations.⁴⁷ Even in the absence of such an exculpation clause, the fact that a duty-of-care violation requires gross negligence means that the risk of being held liable is sharply limited.⁴⁸ Furthermore, most public corporations have so-called "Director & Officer Insurance," which may cover the risk of being held liable for duty-of-care violations.⁴⁹ In addition, corporations are frequently bound by contract to indemnify directors for uninsured judgments.⁵⁰ It is not surprising, therefore, that, in practice, outside directors almost never end up having to pay damages or legal expenses out of their own pocket.⁵¹

43. *Kahn*, 638 A.2d at 1113–14.

44. *See, e.g.*, Jarrad Harford, *Takeover Bids and Target Director's Incentives: The Impact of a Bid on Directors' Wealth and Board Seats*, 69 J. FIN. ECON. 51, 81 (2003) (noting that "outside directors are critical to the internal control function of the board"); Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 934 (2011) (stressing the general importance of outside directors); Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 31 (1987) (noting that "most persons in academia and business agree that outside directors play an important role in the effective functioning of the board").

45. *See* sources cited *infra* note 52.

46. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059 (2006).

47. *See* the sources cited *supra* notes 23–24.

48. *See, e.g.*, Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 43 (2005) (noting the "small likelihood of considered board decisions resulting in personal director liability for a violation of the duty of care"); *see also* Black et al., *supra* note 46, at 1059 ("We find that out-of-pocket payments by outside directors are rare.").

49. Baums & Scott, *supra* note 48, at 43 ("[I]f a director were found liable for a violation of the duty of care, without any element of improper personal gain from self-dealing, the judgment would usually be covered by 'D & O' insurance, paid for by the company."); Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 97 (2008) (noting that most corporations have D&O insurance).

50. Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware's Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319, 323.

51. *See* Black et al., *supra* note 46, at 1062 (concluding, after extensive empirical research, that "outside director liability is, and will in all likelihood remain, a rare occurrence, particularly for companies with state-of-the-art D&O insurance").

Of course, the duty of care is not the only reason for directors to be careful. Reputational incentives must also be considered.⁵² Most directors will want to avoid a reputation for carelessness among the public or their peers,⁵³ and those who have gained such a reputation may find it more difficult to gain directorships in the future.⁵⁴ Many commentators stress the importance of such reputational concerns,⁵⁵ precisely because the risk of being held personally liable is so minuscule.⁵⁶ There are various reasons, however, to doubt the effectiveness of reputational concerns as an incentive to refrain from violations of the duty of care. A particular director's role in the board's decision making process, and the care exercised by that director will often remain hidden from the public's view.⁵⁷ The board's poor business decisions may be easy to observe, but poor business decisions can be due to many factors and so may not tarnish a director's reputation.⁵⁸ Accordingly, outside directors may be tempted to

52. Baums & Scott, *supra* note 48, at 61; see Lucian Arye Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291, 297 (2004) ("Reputational damage might have an adverse effect on the future career prospects of . . . directors."); A. Mechele Dickerson, *Words That Wound: Defining, Discussing, and Defeating Bankruptcy "Corruption"*, 54 BUFF. L. REV. 365, 394 (2006) (noting that "a director's reputation may be one of his most important assets"); Miller, *supra* note 50, at 326 ("Directors value their reputations."); Eric J. Pan, *Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine*, 38 FLA. ST. U. L. REV. 209, 211 (2011) (noting that "directors face very real reputational costs if they fail to meet their fiduciary obligations").

53. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 66 (2004) ("Managers and directors are likely to care about the extent to which relevant social and professional groups view them with approval and esteem."); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315 (1983) (suggesting that "outside directors have incentives to develop reputations as experts in decision control").

54. The idea that poor monitoring might result in labor market penalties was developed early on by Eugene F. Fama and Michael Jensen. See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 294 (1980) (stressing the labor market consequences of poor monitoring for outside directors); Fama & Jensen, *supra* note 53, at 315 (pointing out that the value of an outside director's "human capital depends primarily on [the director's] performance"). Today, the idea that poor monitoring can translate into reputational harm for corporate directors is widely accepted. See, e.g., Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 DEL. J. CORP. L. 417, 434 (2011) ("A person's ability to serve as a corporate director . . . depends heavily on an unimpeachable reputation."); David Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281, 2301 (2004) ("Outside directors who develop reputations as skillful monitors might acquire additional directorships in other firms . . ."). The empirical evidence is somewhat mixed. On the one hand, there is some evidence that, at least in some contexts, poor monitoring can detrimentally affect an outside director's future job prospects. Other studies, however, cast doubt on the effectiveness of reputational incentives. See Yonca Ertimur et al., *Reputation Penalties for Poor Monitoring of Executive Pay: Evidence from Option Backdating*, 104 J. FIN. ECON. 118, 120 (2012) (finding "that involvement in [option backdating] results in significant penalties for CC directors at [backdating] firms but not at other firms").

55. See, e.g., Myers, *supra* note 54, at 433 ("For corporate directors, reputation is extremely important.").

56. See, e.g., David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1833 (2001) ("If a court holds that a manager breached her fiduciary duties, insurance may cover the financial liability, but it is not much help against a shaming sanction.").

57. See, e.g., Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 771 (2002) (noting that "the signal provided by independent directorships is likely to be quite noisy, particularly when the board is large and responsibilities are diffuse").

58. See *id.*; see, e.g., Myers, *supra* note 54, at 434 (noting that failures such as a disappointing merger "generally do not do long-term damage to directors' professional reputations").

free-ride on the efforts of their peers, knowing that their individual contribution to the company's success or failure may remain unobserved.⁵⁹ Furthermore, it must be kept in mind that the central purpose of becoming informed is to monitor—and potentially confront—the firm's management. Given the influence that management has on the nomination of outside directors, such directors may balance reputational benefits with the adverse consequences of raising management's ire.⁶⁰ A director who takes his responsibilities particularly seriously may even fear that the resulting reputation for toughness makes it more difficult to obtain more directorships at other firms, if many of those other firms have managers who resent being monitored too closely.⁶¹

In line with these theoretical concerns, the empirical evidence for reputational penalties against outside directors who engage in poor monitoring is somewhat mixed.⁶² Some studies have presented evidence that reputational sanctions matter.⁶³ For example, a firm's performance has been found to have a positive effect on a director's ability to obtain additional directorships,⁶⁴ whereas directors from firms accused of financial fraud found it more difficult to secure—or hold on to—additional directorships at other firms.⁶⁵ These studies, however, do not address the previously mentioned problem that outside directors may be tempted to free-ride when their reputation is based on the firm's performance rather than on their own, possibly invisible, performance. Moreover, not all studies point in the same direction. For example, one recent study found that directors from firms involved in option backdating were no less suc-

59. Renée B. Adams et al., *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LIT. 48, 73 (2010).

60. See, e.g., Bebchuk et al., *supra* note 57, at 771 (noting that “there are likely to be a considerable number of independent directors who are interested less in establishing reputations as ‘expert decisionmakers’ than in keeping their current board seats and perhaps joining other boards”).

61. Cf. Doron Levit & Nadya Malenko, *The Labor Market for Directors and Externalities in Corporate Governance 2* (July 8, 2012) (Working Paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101874 (arguing that “if . . . boards of other firms are captured by their managers, who want to maintain power, then having a management-friendly reputation can be more useful in getting additional board seats”).

62. Compare Stephen P. Ferris et al., *Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments*, 58 J. FIN. 1087, 1109 (2003) (finding that “firm performance has a positive effect on the number of board seats subsequently held by a director” and concluding that “offers of employment as a director appear to be conditioned by the quality of previous board service as measured by the firm's financial performance”), and Yermack, *supra* note 54, at 2303 (finding only limited evidence that a firm's performance is associated with a greater number of directorships for outside directors), with Yonca Ertimur et al., *supra* note 54, at 137 (finding “that directors at [backdating] and [nonbackdating] firms do not differ in terms of the net change in other seats held”).

63. See Ferris et al., *supra* note 62, at 1109; Yermack, *supra* note 54, at 2303.

64. See Ferris et al., *supra* note 62, at 1109; Yermack, *supra* note 54, at 2303.

65. See Eliezer N. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, 86 J. FIN. ECON. 306, 335 (2007) (finding that “fraud is followed by a large and significant decline in the number of other board appointments held by outside directors” and noting that this “decline is consistent with . . . a reputational penalty being borne by outside directors”); Harford, *supra* note 44, at 77 (finding that after a merger has been completed, outside directors of poorly performing target firms “can expect fewer directorships in the future” where the firm's premerger performance was poor).

cessful than other directors at obtaining additional directorships.⁶⁶ In other words, the extent to which directors incur reputational penalties for poor monitoring remains somewhat unclear. Yet even assuming that directors with a poor monitoring record are in fact less successful at obtaining other directorships, such reputational sanctions are of limited economic weight. After all, unlike managerial compensation,⁶⁷ fees for outside directors typically are not excessive.⁶⁸ It is not surprising, therefore, that many commentators are skeptical regarding the effectiveness of reputational sanctions.⁶⁹

Compare these relatively mild incentives for outside directors with those faced by a controlling shareholder. For the controller, any failure to become reasonably informed may lead to a bad business decision with immediate financial impact, entirely regardless of whether the failure was a merely negligent one or amounted to gross negligence. Moreover, the potential damage is as high as the controlling shareholder's investment in the company, and for the vast majority of public corporations and many privately held ones, that is far more than the entire net worth or the expected future earnings of the average outside director.⁷⁰ In sum, in the vast majority of cases, even in the absence of a general duty of care, the controlling shareholder has far stronger financial incentives to become reasonably informed than do most independent directors. From a policy perspective, therefore, a general duty of care for controlling shareholders is simply unnecessary.

Admittedly, there are two narrowly defined situations where this line of reasoning fails to apply, because the controlling shareholder does not bear the costs of poor management. These two cases involve so-called "looting sales" and lack of economic ownership, and I will turn to them next. Crucially, however, these special and relatively marginal cases do not necessitate the recognition of a general duty of care for controlling shareholders.

66. See Ertimur et al., *supra* note 54, at 137 (finding "that directors at [backdating] and [non-backdating] firms do not differ in terms of the net change in other seats held").

67. For a thorough analysis of the problems associated with managerial compensation see, e.g., BEBCHUK & FRIED, *supra* note 53.

68. Yermack, *supra* note 54, at 2306–07, examines a broad variety of financial incentives for outside directors and estimates that a change in the corporation's market capitalization of about \$2.6 billion leads to financial gains for an outside director of about \$285,000. While these data are for the time period between 1994 and 1996, they suggest that the financial incentives for careful behavior by outside directors pale in comparison with what controlling shareholder stand to win or lose.

69. Cf. Baums & Scott, *supra* note 48, at 61 (noting that none of the incentives facing directors "necessarily creates a strong pressure for directors to . . . work hard to thoroughly understand the company's business and maximize shareholder value"); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 874 (1991) (arguing that neither directors' professional ethos nor the labor market for outside directors provides a persuasive reason "for why outside directors would discharge their functions effectively").

70. See Black et al., *supra* note 46, at 1118–19 (noting that outside directors' settlement in WorldCom case was \$24.75 million—twenty percent of their net worth—whereas the entire settlement was \$6 billion).

2. *Looting Cases*

Under the looting doctrine, a controlling shareholder violates his fiduciary duties when he negligently sells his controlling stake to an apparent looter, who indeed then proceeds to plunder (“loot”) the corporation.⁷¹ The looting doctrine has long been a part of U.S. corporate law and has been recognized by courts in various jurisdictions⁷² including Delaware.⁷³ It has also met with approval in the literature.⁷⁴ Unlike the

71. Ellen S. Friedenberg, *Jaws III: The Impropriety of Shark-Repellent Amendments as a Takeover Defense*, 7 DEL. J. CORP. L. 32, 81–82 (1982) (“A rule that prohibits controlling shareholders and management from knowingly or negligently selling control to a looter is desirable.”); Simone M. Sepe, *Corporate Agency Problems and Dequity Contracts*, 36 J. CORP. L. 113, 126–27 n.69 (2010) (noting that “while controlling shareholders are usually free to sell their block at a control premium that is unavailable to non-controlling shareholders, there are circumstances under which U.S. courts prevent controllers from doing this—such as, for example, the sale to suspected looters”); Marc I. Steinberg, *Some Thoughts on Regulation of Tender Offers*, 43 MD. L. REV. 240, 247 n.32 (1984) (“If a controlling shareholder sells out without making a reasonable investigation of its purchaser . . . he may be held liable for damages incurred by the corporation and minority shareholders due to the purchaser’s looting of the corporation.”); Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 415 (2006) (noting that “a controlling shareholder may not sell her shares to a known or suspected looter”).

72. See, e.g., *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22, 28 (E.D. Pa. 1940) (noting that “owners of control of a corporation occupy a fiduciary relationship to the corporation and its stockholders in respect of the transfer of control and that they owe a duty of due care—a duty in which these defendants failed, with consequent loss to the corporation”); *DeBaun v. First Western Bank & Trust Co.*, 46 Cal. App. 3d 686, 696 (1975) (“That duty of good faith and fairness encompasses an obligation of the controlling shareholder in possession of facts [s]uch as to awaken suspicion and put a prudent man on his guard [that a potential buyer of his shares may loot the corporation of its assets to pay for the shares purchased . . . to conduct a reasonable and adequate investigation [of the buyer].”); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 654 (N.Y. Sup. Ct. 1941) (holding that “gross excessiveness of price . . . may be sufficient to charge a seller with notice of a fraudulent intent on the part of a buyer”). Other cases recognize the looting doctrine in dicta. See, e.g., *Swinney v. Keebler Co.*, 480 F.2d 573, 578 (4th Cir. 1973) (applying North Carolina law); *Harman v. Willbern*, 374 F. Supp. 1149, 1158 (D. Kan. 1974) (applying Kansas law); cf. Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248, 263 (1985) (“In several cases, liability has been imposed on controlling shareholders who sell their shares to ‘looters,’ persons who thereafter criminally convert the assets of the corporation to their own purposes.”). Some courts have refused to apply the looting doctrine unless the seller knew of the buyer’s intention. E.g., *Levy v. American Beverage Corp.*, 265 A.D. 208, 218–19 (1942). This would mean that the looting exemption is part of the duty of loyalty rather than the duty of care.

73. *Harris v. Carter*, 582 A.2d 222, 234–35 (Del. Ch. 1990).

74. See, e.g., Hamilton, *supra* note 72, at 263–68 (defending the looting doctrine against criticism). Easterbrook and Fischel have criticized the looting rule on the ground that “it is difficult if not impossible to detect looters as they approach.” Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 719 (1982). Furthermore, they argue that due to the rarity of actual looters, “almost all” of the refusals to sell induced by the looting doctrine would be “false positives,” meaning that the looting doctrine would typically prevent efficient transactions. *Id.* Against this background, they suggest that instead of holding the seller liable, it would be preferable if looting were deterred by letting the looter be “heavily fined or imprisoned.” *Id.* This critique, however, is not persuasive. By limiting the looting doctrine to cases that involve obvious red flags, the law can ensure that the seller is held liable only in situations where it was not particularly difficult to spot looters. Given the continuing abundance of scam artists, it seems difficult to argue that such cases cannot occur. Cf. Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465, 1491 (1992) (questioning the assumption that looters are hard to detect in advance). In addition, as long as the looting doctrine is defined sufficiently narrowly, it is not clear why that doctrine should lead to more than an insubstantial number of false positives. Hamilton, *supra*, at 72, at 267–68. Moreover, deterring the looter by way of threatening imprisonment or fines may not work to the extent that the looter plans to abscond. In those cases where deterrence fails to work, the minority shareholders would often be stuck with their losses, given that the looter may lack the means to compensate them.

general duty of care for controlling shareholders, a narrowly defined duty of care for looting cases can, in principle, be justified on efficiency grounds. This is because, in looting cases, the controlling shareholder's incentives may in fact be insufficient to protect the minority shareholders. Typically, the controller does not participate in the downside of selling to a looter, because after the sale, when the looter starts plundering the corporation, the seller is no longer invested in the firm. Accordingly, in the absence of a duty of care, the seller typically has little incentive to screen potential buyers. Even worse, the controller may profit from selling to a looter, because the price that the looter offers for the controlling stake may reflect the acquirer's expected profits from plundering the corporation at the expense of the minority shareholders. Courts seem very much aware of this problem. Indeed, they have traditionally been particularly willing to apply the looting doctrine in scenarios where the controlling shareholder parted with his stake at an obviously excessive price, and thus "sold out" the minority shareholders.⁷⁵ There is then, in looting cases, a strong case to be made for a duty of care for controlling shareholders.

3. *Lack of Economic Ownership*

A second scenario in which a duty of care may be needed in order to incentivize controlling shareholders to act in the best interests of minority shareholders is one in which controlling shareholders do not hold economic ownership of the corporation. Economic ownership, simply put, is the economic interest in the corporation, including, most notably, gains and losses that result from changing share prices.⁷⁶ As Bernard Black and Henry Hu have shown in their groundbreaking work on empty voting, modern capital markets make it relatively easy to decouple voting rights from economic ownership.⁷⁷ For example, shares can be "borrowed" so that the borrower can exercise the voting rights without becoming the economic owner.⁷⁸ Alternatively, parties can use equity

See id. (noting that "the innocent shareholders and others 'left behind' will usually suffer the entire economic loss").

75. *See, e.g., Gerdes*, 28 N.Y.S.2d at 654 (holding that "gross excessiveness of price . . . may be sufficient to charge a seller with notice of a fraudulent intent on the part of a buyer"); *Insuranshares Corp.*, 35 F. Supp. at 24 (viewing the excessive price as "strongly indicative of the true nature of the transaction"); *Dale v. Thomas H. Temple Co.*, 208 S.W.2d 344, 352 (Tenn. 1948) (finding "the selling price . . . so far in excess of the market . . . as to constitute a badge of fraud"). *But see Clagett v. Hutchison*, 583 F.2d 1259, 1266 (4th Cir. 1978) (Butzner, J., dissenting) (arguing that the "payment of . . . an excessive premium . . . might well reflect the real value of the stock").

76. The term "economic ownership" refers to the shareholder's economic rights such as "dividend, liquidation, and appraisal rights under corporate law, and gain (loss) from an increase (decrease) in trading prices." Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 633 (2008) [hereinafter *Equity and Debt Decoupling*].

77. *Id.* at 629; Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006) [hereinafter *The New Vote Buying*].

78. *The New Vote Buying*, *supra* note 77, at 816.

swaps, with the party holding the “long equity side” acquiring economic ownership without voting rights from the “short side.”⁷⁹

It is therefore possible for a shareholder to control a majority of the votes without being personally vulnerable to any of the negative consequences that his voting behavior may have for the corporation. This opens up the possibility of a controller voting in a way that he knows, and even intends, to be inconsistent with the best interests of the corporation. For example, in cases of corporate acquisition, an investor may own a substantial number of shares in the target corporation while holding only voting rights (without concomitant economic ownership) in the acquirer. How will that investor vote his shares in the acquirer if he believes that the merger agreement is overly generous to the target shareholders? Since the investor is one of the shareholders of the target corporation and since he does not have to bear the deal’s negative impact on the acquiring corporation, he has every reason to vote in favor of the merger.⁸⁰

Lack of economic ownership—or even negative economic ownership—may not just be a problem in cases where the controller knowingly harms the corporation’s interests, however. Rather, carelessness can be a problem as well. A controller who is only formally, but not economically, invested in a corporation may lack sufficient incentives even to become reasonably informed.⁸¹ In practice, such cases are unlikely to be frequent. While instances of empty voting are no longer unusual,⁸² documented examples involve the acquisition of voting rights below the threshold of corporate control.⁸³ Moreover, the chief concern with empty voting is not that the “empty voter” will fail to be reasonably informed, but that he will consciously vote against, or at least without regard for, the corporation’s interest.⁸⁴

None of this, however, excludes the possibility that investors will manage to acquire control of a corporation without meaningful economic ownership, and that such controllers will sometimes exercise their influence without bothering to become reasonably informed regarding the consequences that their decisions have for the controlled corporation. By imposing a duty of care, the law can correct this deficit at least to some extent.

Even then, however, this duty of care needs to be limited in accordance with general principles. Delaware courts have traditionally been reluctant to apply fiduciary duties to a majority owner who does nothing more than exercise his voting rights.⁸⁵ This has been true even for the du-

79. *Id.*

80. *See id.* (describing an example in which a hedge fund that owned shares in the target corporation subsequently acquired a substantial number of voting rights in the acquiring corporation).

81. *See id.* at 815.

82. *Id.* at 816, 863.

83. *See id.* at 816.

84. *Id.* at 815 (“In an extreme case, an investor can vote despite having negative economic ownership, which gives the investor an incentive to vote in ways that reduce the company’s share price.”).

85. *See, e.g., In re Gen. Motors Class H S’holders Litig.*, 734 A.2d 611, 613 (Del Ch. 1999).

ty of loyalty: despite the fact that controlling shareholders owe the corporation a duty of loyalty, they are free to exercise their voting rights in their own best interest, even where that interest conflicts with the best interest of the corporation.⁸⁶ Exceptions to this rule are conflict-of-interest transactions between the controller and the controlled corporation, which must be entirely fair to the minority shareholders.⁸⁷ In the case of empty voting, it may be advisable for the law to take a tougher approach. Bernard Black and Henry Hu have suggested adopting, at a minimum, a rebuttable presumption that shareholders with negative economic ownership (i.e., shareholders with a net short position) should not be allowed to vote at all.⁸⁸ There is much to be said for such rule, given that shareholders with negative economic ownership can hardly be expected to vote in the company's best interest.

To the extent that empty voters are allowed to vote, though, the question remains to what extent controlling shareholders without economic ownership should be held liable for duty-of-care violations where they have done nothing but exercise their voting rights. Imposing liability in such cases seems highly questionable. After all, small minority shareholders typically vote their shares without becoming informed.⁸⁹ For small shareholders, such "rational ignorance" is a simple consequence of the fact that the costs of becoming informed outweigh their share in the potential benefits of informed voting.⁹⁰ But if minority shareholders are allowed to vote in blessed ignorance, it is not obvious that one should demand more of controlling shareholders. Note that this corresponds to existing Delaware case law.⁹¹ Despite dicta recognizing a general duty of care for controlling shareholders, the Chancery Court has made it clear that no such duty attaches where the controlling shareholder fails to direct the actions of the corporation.⁹²

In sum, while a duty of care for controlling shareholders without an economic interest in the controlled corporation seems defensible, that

86. Thorpe *ex rel.* Castleman v. CERBCO, 676 A.2d 436, 437 (Del. 1996) (holding that controlling shareholders are entitled "to act in their self-interest" when voting under Section 271 of the Delaware General Corporation Law).

87. See Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987) (noting that the controlling shareholder's right to vote his shares in his own interest is limited by the fiduciary duty he owes to the minority shareholders and that a transaction—in this case a squeeze-out merger—in which the controller stands on both sides of the transaction still has to be entirely fair to the minority shareholders); see also *Equity and Debt Decoupling*, *supra* note 76, at 702 ("The primary exception [from the rule that the controlling shareholder can vote his shares in his own interest] is the fiduciary duty of a controlling shareholder to treat minority shareholders fairly in a freezeout or other self-dealing transaction.").

88. *Equity and Debt Decoupling*, *supra* note 76, at 702.

89. Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1837 n.28 (1989).

90. E.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1473 n.126 (1992); Bebchuk, *supra* note 89, at 1837 n.28; Michael S. Kang, *Shareholder Voting as Veto*, 88 IND. L.J. 1299, 1313 (2013).

91. See, e.g., *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 613 (Del. Ch. 1999).

92. *Cinerama, Inc. v. Technicolor, Inc.*, Civ. A. No. 8358, 1991 WL 111134, at *19 (Del. Ch. June 24, 1991), *aff'd in part, rev'd on other grounds sub nom. Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

duty should be limited to cases where the controller does more than simply exercise his voting rights (e.g., gives instructions to board members or otherwise directs the board's actions).

III. THE CASE LAW

In this Part, I trace the historical development of the case law that bears on the controller's duty of care. This analysis yields two main insights. First, the precedential basis for the general duty of care is exceedingly weak. While Delaware's courts have acknowledged the existence of such a duty in various dicta,⁹³ there is not a single case in which a controlling shareholder was actually found liable for a mere violation of his general duty of care.

Second, while the Delaware Chancery Court and the Delaware Supreme Court have explicitly recognized a general duty of care,⁹⁴ they have done little to justify such a duty. Rather, the relevant dicta rely almost exclusively on the "assumption argument," i.e., the argument that a controlling shareholder who directs the corporation's actions must assume the fiduciary duties of the board of directors.⁹⁵

A. *The Looting Cases*

Among those Delaware cases where the controller's duty of care is mentioned, two are so-called "looting cases." The looting doctrine has a long tradition in U.S. corporate law, and courts in various U.S. states adopted it long before Delaware did.⁹⁶ It is therefore unsurprising that the Delaware Chancery Court followed in their footsteps. The more interesting aspect of the relevant decisions is the doctrinal footing on which the Chancery Court placed the looting doctrine.

I. *Harris v. Carter*

*Harris v. Carter*⁹⁷ is the first case in which the Chancery Court recognized the looting doctrine. The Carter Group owned fifty-two percent of the stock of Atlas Energy Corporation ("Atlas"),⁹⁸ a Delaware corporation engaged in oil and gas exploration and production.⁹⁹ In 1986, the Carter Group entered into a bargain with the Mascolo Group under which the former exchanged its Atlas shares for shares in another company called Insuranshares of America ("ISA").¹⁰⁰ According to the plain-

93. See *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d at 619.

94. See, e.g., *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009); *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d at 619.

95. See *Harris v. Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).

96. See sources cited *supra* note 71.

97. 582 A.2d 222 (Del. Ch. 1990).

98. *Id.* at 225.

99. *Id.*

100. *Id.*

tiff, who was a minority shareholder of Atlas, the Mascolo Group then proceeded to engage in numerous self-dealing transactions with Atlas to the detriment of both Atlas and its minority shareholders.¹⁰¹ Against this background, the plaintiff argued that the Carter Group had violated its duty of care by failing to investigate the buyer.¹⁰² Faced with a motion to dismiss, the Delaware Supreme Court was unwilling to exclude the possibility that Delaware law might sometimes impose a duty of care on the seller of a controlling stake:

It is sufficient to require denial of this motion to dismiss that I cannot now say as a matter of law that under no state of facts that might be proven could it be held that a duty arose, to the corporation and its other shareholders, to make further inquiry and was breached. In so concluding I assume without deciding that a duty of care of a controlling shareholder that may in special circumstances arise in connection with a sale of corporate control is breached only by grossly negligent conduct.¹⁰³

How did the court argue for the possibility the controller's duty of care? Rather than relying on a legal policy analysis, the court invoked two doctrinal arguments.

To begin, the court found a basis for the duty of care in the law of torts, specifically in the principle that "each person owes a duty to those who may foreseeably be harmed by her action to take such steps as a reasonably prudent person would take in similar circumstances to avoid such harm to others."¹⁰⁴ Of course, this general principle is a rather troublesome basis for the duty of care, not least because it is far too broad. For example, there is widespread agreement that Delaware law does not require minority shareholders to become adequately informed before voting,¹⁰⁵ despite the fact that uninformed voting may harm the company.

Hence, it is unsurprising that the court also invoked a second argument: it stressed that "when a shareholder presumes to exercise control over a corporation, to direct its actions, that shareholder assumes a fiduciary duty of the same kind as that owed by a director to the corporation."¹⁰⁶

101. *Id.* at 226.

102. *Id.* at 224.

103. *Id.* at 235–36.

104. *Id.* at 234–35.

105. In fact, there is widespread agreement that, at least in public corporations, minority shareholders generally do not owe any fiduciary duties to the corporation or to other shareholders. Delaware courts, in particular, have only imposed fiduciary duties on controlling shareholders. *See, e.g., Kahn ex rel. Kahn v. Lynch Commc'n Sys.*, 638 A.2d 1110, 1113 (Del. 1994); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987). The same is true in other states. *See, e.g., Hunt v. Data Mgmt. Res.*, 985 P.2d 730, 732 (Kans. Ct. App. 1999) (holding that the "law does not impose a strict fiduciary duty on a shareholder to act in the best interests of the corporation").

106. *Harris*, 582 A.2d at 234.

2. Abraham v. Emerson Radio Corp.

In the 2006 *Abraham v. Emerson Radio Corp.* decision,¹⁰⁷ the Chancery Court once again addressed the looting scenario. Emerson Radio Corp. (“Emerson”) owned 53.2% of the shares of Sport Supply Group, Inc. (“Sport Supply”), a direct marketer of sport supplies.¹⁰⁸ In 2005, Emerson sold its majority stake to Collegiate Pacific, Inc. at a premium of eighty-six percent over the prior day’s closing price.¹⁰⁹ According to the plaintiff, the acquirer intended to loot the controlled corporation, taking its assets without paying for them.¹¹⁰ The plaintiff, a long-term owner of thousands of shares of nominal defendant Sport Supply Group, Inc., also claimed that Emerson knew or should have known that the acquirer intended to enrich itself at the expense of Sport Supply’s minority shareholders.¹¹¹ Accordingly, the plaintiff brought suit against Emerson, demanding that the latter share the control premium it had received with Radio Supply’s minority shareholders.¹¹²

Following a motion by the defendant, the Chancery Court dismissed the complaint.¹¹³ It noted that the plaintiff had failed to plead any specific facts suggesting that the buyer sought to loot the controlled corporation or that the seller should have been aware of this intention.¹¹⁴ Hence, the outcome of the case did not turn on whether the looting doctrine was part of Delaware law. Nonetheless, the Chancery Court used the opportunity to address, and limit, the looting doctrine:

Although Emerson has not raised the issue, I am dubious that our common law of corporations should recognize a duty of care-based claim against a controlling stockholder for failing to (in a court’s judgment) examine the bona fides of a buyer, at least when the corporate charter contains an exculpatory provision authorized by 8 *Del. C.* § 102(b)(7). After all, the premise for contending that the controlling stockholder owes fiduciary duties in its capacity as a stockholder is that the controller exerts its will over the enterprise in the manner of the board itself. When the board itself is exempt from liability for violations of the duty of care, by what logic does the judiciary extend liability to a controller exercising its ordinarily unfettered right to sell its shares? I need not answer that question here¹¹⁵

This passage is remarkable for two reasons. First, it suggests that even in looting cases, it is not at all clear that Delaware law recognizes a duty of care for controlling shareholders. Second, and more importantly,

107. 901 A.2d 751 (Del. Ch. 2006).

108. *Id.* at 753.

109. *Id.* at 754.

110. *Id.* at 755.

111. *Id.* at 756–57.

112. *Id.* at 761.

113. *Id.* at 752.

114. *Id.*

115. *Id.* at 759.

the court reinforces the importance of the assumption argument by using it to curtail the extent of any duty of care: because the controller's duty of care is derived from that of corporate directors, it must be subject to the same limitation in the form of an exculpation clause.

B. Cases Affirming a General Duty of Care

The looting cases involve a narrowly defined scenario, namely the (grossly) negligent sale of a controlling stake to a buyer with nefarious intentions. The much more relevant question is whether controlling shareholders have a *general* duty of care towards the corporation or the minority shareholders. In a number of dicta, Delaware courts have answered that question in the affirmative.

I. Cinerama v. Technicolor

The first and most frequently cited case in this area is the Chancery Court's 1991 *Cinerama v. Technicolor* decision.¹¹⁶ The pertinent facts can be summarized as follows: A subsidiary of the MacAndrews & Forbes Group ("MAF") purchased all of the outstanding stock of Technicolor in a so-called two-step acquisition: In the first step, MAF launched a tender offer for Technicolor's stock, thereby becoming Technicolor's majority shareholder.¹¹⁷ In the second step, MAF undertook a squeeze-out merger with Technicolor, designed to get rid of Technicolor's remaining shareholders.¹¹⁸ The plaintiff, who was the beneficial owner of 4.4% of Technicolor's shares,¹¹⁹ had declined to tender his stock in the first stage of the acquisition.¹²⁰ Further, the plaintiff objected to the merger that followed and sought appraisal of his shares.¹²¹ In addition, the plaintiff alleged a violation of fiduciary duties. In particular, he argued that MAF, as controlling shareholder, violated its duty to pay a fair price for the shares of the minority shareholders.¹²²

It is in this context that the Chancery Court addressed the fiduciary duties of controlling shareholders. In previous case law dealing solely with the duty of loyalty, the court had already made the argument that the controlling shareholder who directs the actions of the corporation assumes the directors' fiduciary duty of loyalty.¹²³ In *Cinerama*, the court worded its reasoning more broadly, extending it to include the duty of care as well:

116. Civ. A. No. 8358, 1991 WL 111134 (Del. Ch. June 24, 1991), *aff'd in part, rev'd on other grounds sub nom. Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

117. *Id.* at *8.

118. *Id.*

119. *Id.* at *1.

120. *Id.*

121. *Id.*

122. *Id.* at *2.

123. *Id.* at *19.

A fiduciary duty is imposed upon controlling shareholders in certain circumstances not formalistically, but for good reason. That protective device is in substitution for the protection that a corporation or its shareholders ordinarily receives from the business judgment of the men and women who comprise the company's board of directors. Thus, when a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of the corporation. When, on the other hand, a majority shareholder takes no such action, generally no special duty will be imposed.¹²⁴

It is important to note that the court's words on the duty of care were not part of the holding, since no duty-of-care violation had been alleged. Nonetheless, the court's reasoning has continued to influence later cases.

2. Pfeffer v. Redstone

The next case mentioning the controller's duty of care was the Chancery Court's 2008 *Pfeffer v. Redstone* decision.¹²⁵ The case involved a Delaware parent corporation, Viacom, that owned a majority interest in a subsidiary, Blockbuster.¹²⁶ In 2004, the parent corporation parted with that majority interest¹²⁷ by offering its own shareholders the opportunity to exchange their shares in the parent corporation for shares in the subsidiary.¹²⁸ In the following two years, Blockbuster's performance declined.¹²⁹ This prompted one of Blockbuster's shareholders, who had participated in the share exchange, to bring suit.¹³⁰ Among the defendants was not just Viacom, but also Viacom's controlling shareholder, National Amusements, Inc. ("NAI").¹³¹ However, the Chancery Court dismissed the complaint against NAI as frivolous.¹³² To justify this decision, the court pointed to the lack of evidence that NAI had directed Viacom's actions and explained:

As noted in *Cinerama, Inc. v. Technicolor, Inc.*, "when a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of a corporation. When, on the other hand, a majority shareholder takes no such action, generally no special duty will be imposed."¹³³

124. *Id.*

125. Civ. A. No. 2317-VCL, 2008 WL 308450 (Del. Ch. Feb. 1, 2008).

126. *Id.* at *1.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.* at *1.

132. *Id.* at *14.

133. *Id.* at *14 n.72.

In the case at hand, the fact that NAI had not directed the actions of the corporation it controlled made it unnecessary to analyze the duty of care question further. The plaintiff subsequently appealed to the Delaware Supreme Court, but the latter affirmed and noted that the Delaware Chancery Court had properly relied on *Cinerama*.¹³⁴

3. Shandler v. DLJ Merchant Banking

The last of the nonlooting cases concerning the controller's duty of care is the Chancery Court's 2010 decision in *Shandler v. DLJ Merchant Banking*.¹³⁵ In 1998, DLJ Funds ("DLJ") became the controlling shareholder of Insilco Technologies Inc. ("Insilco").¹³⁶ Only six years later, Insilco had to file for bankruptcy.¹³⁷ According to the plaintiff, DLJ had used these six years to engage in various activities to the detriment of Insilco. In particular, the plaintiff alleged that DLJ caused the controlled company to pay excessive fees to advisors affiliated with DLJ, to sell one of Insilco's businesses at an inadequate price to another company affiliated with DLJ, and to delay the filing of insolvency petitions for the benefit of DLJ.¹³⁸

Confronted with a motion to dismiss, the Chancery Court analyzed these allegations with respect to both the duty of loyalty and the duty of care.¹³⁹ Noting that the controlled corporation's certificate of incorporation contained an exculpation clause, the court dismissed any claims based on duty-of-care violations:

Because, however, the premise of controlling stockholder fiduciary responsibility is to hold the controller liable for actions its [sic] causes using its control of the company's board, liability under this theory is largely coextensive with the liability faced by the corporation's directors. That is, a controlling stockholder cannot be held liable for a breach of the duty of care when the directors are exculpated.¹⁴⁰

This passage is remarkable for two reasons. First, it makes evident the central role that the assumption argument plays in the court's duty-of-care jurisprudence: as in *Emerson*, that argument is now used not only to justify the duty of care, but also to limit its extent. Second, the court seems to opt for a uniform understanding of the controller's duty of care in both looting and nonlooting cases, by suggesting that exculpation clauses can limit the liability for duty-of-care violations not just in the former scenario, but also in the latter.

134. *Pfeffer v. Redstone*, 965 A.2d 676, 691 (Del. 2009).

135. Civ. A. No. 4797-VCS, 2010 WL 2929654 (Del. Ch. July 26, 2010).

136. *Id.* at *1.

137. *Id.*

138. *Id.* at *3.

139. *Id.* at *12.

140. *Id.* at *16 (citations omitted).

IV. THE DOCTRINAL CASE AGAINST THE DUTY OF CARE

In light of the policy arguments against the duty of care, only one question remains: how strong is the doctrinal case for such a duty? As previously shown, that case rests on the claim that a controlling shareholder who directs the actions of the corporation “assumes the duties of care and loyalty of a director of the corporation.”¹⁴¹

In this Part, I argue that the assumption argument is unpersuasive. It simply ignores the differences between director and shareholder incentives. Moreover, the assumption argument is plainly at odds with the modern development of the doctrine on the duty of loyalty, during which courts have long recognized that it would be inappropriate to subject corporate directors and controlling shareholders to identical constraints.¹⁴² In addition, the assumption argument cannot explain the duty-of-care doctrine in the so-called “looting cases,” and it generates unacceptable implications for exculpation clauses.

A. *The Failure to Take Different Incentives into Account*

At the core of the assumption argument is the claim that the controller’s duty of care is a “protective device . . . in substitution for the protection that a corporation or its shareholders ordinarily receives from the business judgment of the men and women who comprise the company’s board of directors.”¹⁴³ Of course, the problem with this argument is that it fails to ask why such substitution is necessary. As previously explained, corporate directors and controlling shareholders face very different incentives from one another. The former do not bear the economic consequences of their decision, and so a duty of care may provide an otherwise absent incentive to become informed. By contrast, the latter are heavily invested in the corporation, making a general duty of care quite unnecessary. In other words, it is simply not true that minority shareholders need a duty of care to be imposed upon the controlling shareholder in order for their interests to be as well protected as they are when guarded by the judgment of corporate directors.

In this context, it is also worth pointing out the difference between the controlling shareholder’s duty of loyalty and his duty of care. The former is necessary for both directors and controlling shareholders. After all, in the absence of such a duty, both corporate directors and controlling shareholders may find it expedient to enrich themselves at the expense of the corporation. With respect to the duty of care, however, the situation is different: while corporate directors may have insufficient incentives to become informed, that simply is not the case for controlling

141. Civ. A. No. 8358, 1991 WL 111134, at *19 (Del. Ch. June 24, 1991), *aff’d in part, rev’d on other grounds sub nom.* Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993).

142. *Id.*

143. *Id.*

shareholders. In sum, the logic underlying the assumption argument is fundamentally flawed.

B. Lack of Fit

The assumption argument faces a further problem in that it cannot adequately explain Delaware's law on the duty of care. As previously noted, Delaware's case law on the controller's duty of care is most convincing when it comes to the "looting cases," in which a controlling shareholder is held liable for selling his stake to an apparent looter. Yet despite the fact that the Delaware Chancery Court has invoked the assumption argument in its original looting decision, *Harris v. Carter*, the Court's formulation of the looting doctrine is ultimately inconsistent with the assumption argument. In *Harris v. Carter*, the Court concluded:

[W]hile a person who transfers corporate control to another is surely not a surety for his buyer, when the circumstances would alert a reasonably prudent person to a risk that his buyer is dishonest or in some material respect not truthful, a duty devolves upon the seller to make such inquiry as a reasonably prudent person would make, and generally to exercise care so that others who will be affected by his actions should not be injured by wrongful conduct.¹⁴⁴

For the assumption argument, this statement proves troublesome in two respects. First, the cited passage does not distinguish between active controllers and those who simply hold a majority stake without getting involved in the management of the corporation. Nor would such a distinction make sense. A merely passive majority shareholder who sells his stake to a looter is endangering the minority shareholders just as much as a seller who was in the habit of getting involved in the management of the corporation. That, of course, creates an obvious problem for the assumption argument. According to the assumption argument, the controlling shareholder's duty of care arises only if, and because, the controller has directed the actions of the corporations and thereby assumed the role of the board.¹⁴⁵

Moreover, and perhaps more importantly, the idea that the controlling shareholder's duty of care arises only because the controller has directed the actions of the corporations, and thereby assumed the role of the board, really is completely inconsistent with the looting doctrine. This is because, in the looting cases, the transaction that threatens the minority shareholders is the sale of the controlling stake, which may not involve the board of the controlled corporation at all.¹⁴⁶ In other words,

144. 582 A.2d 222, 235 (Del. Ch. 1990).

145. *Cinerama, Inc.*, 1991 WL 111134, at *19 (Del. Ch. June 21, 1991), *aff'd in part, rev'd on other grounds sub nom. Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

146. For the sake of completeness, it is worth noting that there is one exception to this rule. If the acquirer of a controlling stake seeks to undertake a merger or another fundamental transaction with the controlled corporation within three years, he may need the approval of the incumbent directors

the danger contained by the looting doctrine is not a danger arising from interference with the board, and therefore cannot justify the imposition of a duty of care under the assumption argument.

C. Duty of Care v. Duty of Loyalty

A further argument against the assumption argument comes from the Delaware courts' jurisprudence on the duty of loyalty. In order for the assumption argument to justify the imposition of the duty of care, it would have to be the case that the controlling shareholder assumes the same duties that corporate directors have. Indeed, this has been the thrust of the Delaware case law on the duty of care.¹⁴⁷ The notion, however, that directors and controlling shareholders have identical fiduciary duties is squarely in conflict with Delaware's case law on the controlling shareholder's duty of loyalty. Delaware courts have long acknowledged that the duty of loyalty imposed on controlling shareholders is a very different constraint from the duty of loyalty imposed on corporate directors.¹⁴⁸

This becomes particularly plain in the case of self-dealing transactions. Where a corporate director stands on both sides of the transaction, that transaction is subject to the entire fairness test.¹⁴⁹ The conflict of interest can be "neutralized," however, by either a majority vote of the disinterested directors, or by a shareholder vote.¹⁵⁰ If either of these requirements is met, the transaction is protected by the business judgment rule.¹⁵¹ By contrast, courts are much stricter when a controlling shareholder stands on both sides of the transaction.¹⁵² Here, the general rule is that the transaction remains subject to the entire fairness test even if it has been approved by the shareholders and/or the disinterested directors.¹⁵³ The most that the controlling shareholder can obtain is a reversal in the burden of proof.¹⁵⁴

There is one special scenario, namely mergers between the controller and the controlled corporation, for which a 2014 decision by the Delaware Supreme Court relaxes the rules governing controlling share-

under Delaware's business combination statute. DEL. CODE ANN. tit. 8, § 203 (2014). For that reason, the controlled corporation's board sometimes gets involved in a private sale of control.

147. See *supra* Part II.

148. *Cinerama, Inc.*, 1991 WL 111134, at *19.

149. *Cheffin v. GNI Group, Inc.*, Civ. A. No. 16211-NC, 1999 WL 721569, at *5 (Del. Ch. Sept. 3, 1999).

150. *Id.*

151. *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987); *Cooke v. Oolie*, Civ. A. No. 11134, 2000 WL 710199, at *13 (Del. Ch. May 24, 2000); *Chaffin*, 1999 WL 721569, at *5. The only question in this context is whether, in case of approval by disinterested directors, the disinterested directors approving the transaction have to constitute a majority of the board. Compare *Cooke*, 2000 WL 710199 89, at *13 (not imposing such a requirement), with *Chaffin*, 1999 WL 721569, at *5 (demanding that the disinterested directors approving the transaction constitute a majority of the board).

152. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).

153. *Id.*

154. *Id.* at 429.

holders.¹⁵⁵ According to the most recent case law, such mergers may in fact be protected by the business judgment rule if the merger is conditional upon the approval of *both* the minority shareholders and an independent committee.¹⁵⁶ Yet, even these relaxed requirements are more stringent than those governing transactions that only involve corporate directors, for in the latter type of case, independent director approval and shareholder approval are *alternative* ways of shielding the transactions rather than requirements that have to be fulfilled *cumulatively*.¹⁵⁷

This difference between the requirements for controlling shareholders and those for corporate directors is no accident. Rather, Delaware courts have recognized very explicitly that the threat posed by controlling shareholders is different from the one posed by corporate directors.¹⁵⁸ This insight should not be limited to the duty of loyalty. Rather, it is time to recognize that a one-size-fits-all duty of care would be just as inappropriate as a one-size-fits-all duty of loyalty. More specifically, while it may make sense to impose a general duty of care upon corporate directors, the duty of care for controlling shareholders should be limited to cases of looting sales and lack of economic ownership.

D. *The Exculpation Dilemma*

Finally, the assumption argument leads to somewhat bizarre consequences when applied to exculpation clauses. As the Chancery Court has acknowledged, if the duty of care of controlling shareholders is derived from—and coextensive with—the duty of care of corporate directors, then one cannot reasonably hold controlling shareholders liable for mere duty-of-care violations in cases where the corporation's directors are protected by an exculpation clause.¹⁵⁹

Yet, that result is highly problematic. Given that the controlling shareholder controls both the board and the shareholder meeting,¹⁶⁰ allowing charter provisions that eliminate his liability for duty-of-care violations is tantamount to letting the controlling shareholder decide whether or not he wants to be liable for duty-of-care violations. That is plainly absurd. If one takes the view that a duty of care for controlling shareholders is generally harmful, then the legal default should not include such a duty, and accordingly, there should be no need for an excul-

155. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014).

156. *Id.*

157. *Id.*; see Chaffin v. GNI Group, Inc., Civ. A. No. 16211-NC, 1999 WL 721569, at *5 (Del. Ch. Sept. 3, 1999).

158. *Tremont Corp.*, 694 A.2d at 428 (noting “the reality that in [a merger between the controller and the controlled corporation] . . . the controlling shareholder will continue to dominate the company regardless of the outcome of the transaction” and pointing out the “risk . . . that those who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation by the controlling shareholder”).

159. Shandler v. DLJ Merch. Banking, Inc., Civ. A. No. 4797-VCS, 2010 WL 2929654, at *16 (Del. Ch. July 26, 2010).

160. Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 32–33 (1999).

pation clause. If, alternatively, a duty of care is appropriate, then the controlling shareholder should not be allowed to opt out of that duty at all.

In sum, the assumption argument is utterly unconvincing. It is logically flawed, fails to explain the case law on the duty of care, is inconsistent with the case law on the duty of loyalty, and leads to unacceptable consequences with respect to exculpation clauses. Hence, the assumption argument simply does not provide a doctrinal basis for a general duty of care for corporate controllers.

V. CONCLUSION

One of corporate law's dogmas is that controlling shareholders have a general duty of care towards the corporation. In this Essay, I have argued that this dogma is really a myth, and one that should be abandoned. Except for two narrowly defined situations—sales to corporate looters and lack of economic ownership—controlling shareholders already have strong financial incentives to be reasonably informed. Hence, there is no need for a duty of care.

Moreover, such a duty of care cannot be defended on the grounds of *stare decisis*. No Delaware court has ever found a controller liable for violating the general fiduciary duty of care. Admittedly, there is no shortage of dicta recognizing a general duty of care for corporate controllers. These dicta, however, are based on poor doctrinal reasoning and are therefore unpersuasive. It is time, therefore, to recognize that a general duty of care for corporate controllers does not, and should not, exist.